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WAR DEPARTMENT TECHNICAL MANUAL

ADMINISTRATIVE AUDIT PROCEDURES FOR COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

WAR DEPARTMENT • 1 MARCH 1944

WAR DEPARTMENT TECHNICAL MANUAL
TM 14-1000

This manual supersedes the Manual for Administrative Audit of Cost-Plus-a-Fixed-Fee Supply Contracts, 14 August 1942

ADMINISTRATIVE AUDIT PROCEDURES FOR COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

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FOREWORD

Changes to this manual will be supplied on a page basis, and will be published as required. As change pages are received they will be inserted in their proper places, and the replaced pages destroyed.

Each page of the manual bears a date in its upper inside corner. This date is the date of the publication. Pages which represent changes will carry the date of the change and the number of the change, for example, "C–1," "C–2," and so on.

Paragraphs are numbered consecutively throughout the entire book. Paragraphs carrying decimal suffixes indicate newly added material; for example, a paragraph numbered 123.1 represents the first main paragraph following paragraph 123.

Pages are numbered consecutively throughout the book. If new pages are added within the book, the added pages will carry alphabetical suffixes—"A," "B," "C," and so on. For example, if a new page is added between 101 and 102, the page will be numbered 101–A. A second additional page in the same place would be numbered 101–B, and so on.

Chapters 1, 2, and 3 of this manual are furnished as announced in the Foreword of chapter 4 which was issued 18 December 1943. These chapters should be inserted under the same cover as chapter 4.

Chapters 1, 2, and 3 supersede the material contained in Manual for Administrative Audit of Cost-Plus-a-Fixed-Fee Supply Contracts issued 14 August 1942.

INTRODUCTION

TM 14–1000, Administrative Audit Procedures for Cost-Plus-A-Fixed-Fee Supply Contracts is issued in accordance with the memorandum, Headquarters, Services of Supply, 27 May 1942, approved by the Under Secretary of War. It is prescribed for use by all agencies of the War Department charged with the administration of cost-plus-a-fixed-fee supply contracts, and is to be applied to existing as well as future contracts of this type.

Cost Interpretations which serve as guides on technical matters relating to allowability of costs for reimbursement purposes will be issued as chapter 5 of this manual.

In addition, audit staff instructions will continue to be issued by the Fiscal Branch, headquarters of each of the services and of the Army Air Forces, with the concurrence of the Office of the Fiscal Director, Headquarters, Army Service Forces. The name of the service or the Army Air Forces will be prefixed to the title as, for example, "Ordnance Audit Staff Instructions." These instructions will include matters relating to reports of status of audit work, channels of correspondence, and, generally, instructions relating to the administrative supervision of the audit staff.

Because of varying procedural requirements in the individual services and Army Air Forces, some variation in the content of these instructions is permissible but uniformity should be an objective. Only instructions of wide or general application are to be included and not those applying to a specific project or a relatively small number of projects. The latter instructions will be issued in letter form and are not to become part of the formal audit staff instructions.

CONTENTS

		Paragraphs	Page
Chapter 1.	**Introduction.**		
Section I.	General	1–12	1
II.	Reimbursement policies	13–14	3
III.	Documentary evidence requirements of General Accounting Office	15–30	3
Chapter 2.	**Review and appraisal of contractor's procedures.**		
Section I.	General survey	31–32	8
II.	Accounting policies of contractor	33–37	8
III.	General nature of internal control	38–44	10
IV.	Outline of procedure for review and appraisal of internal control	45–48	12
V.	Invoices	49–60	12
VI.	Pay rolls	61–74	15
VII.	Journal entries	75–82	17
VIII.	Miscellaneous	83–90	19
Chapter 3.	**Application of selective audit procedures.**		
Section I.	Introduction	91– 99	21
II.	Invoices	100–110	23
III.	Pay rolls	111–116	26
IV.	Journal entries	117–125	28
V.	Miscellaneous	126–133	31
Chapter 4.	**Final settlement of cost-plus-a-fixed-fee supply contracts.**		
Section I.	General	201–207	61
II.	Procedures for final settlement which have general applicability	208–223	63
III.	Additional procedures for final settlement applicable in 100 percent CPFF plants where all CPFF contracts are terminated	224–228	66
IV.	Additional procedures for final settlement applicable in all cases in mixed plants	229	67
Appendix			69

This manual supersedes The Manual for Administrative Audit of Cost-Plus-a-Fixed-Fee Supply Contracts, 14 August 1942.

CHAPTER 1

INTRODUCTION

SECTION I

GENERAL

1. Purpose of administrative audit.

a. The purpose of the administrative audit of cost-plus-a-fixed-fee (CPFF) supply contracts is to ascertain that the claims for reimbursement made by the contractor are in accordance with the provisions of the contract, and that they are substantiated by his records and other supporting evidence. The auditor should consider the twofold aspect of every cost claimed: Has the item of cost actually been incurred, and is it allowable under the terms of the contract?

b. In carrying out his audit the auditor has the responsibility of developing an audit program which will protect the interests of the Government. At the same time, however, the auditor must not extend his procedures unnecessarily or needlessly duplicate the work of the contractor. He should cooperate in obtaining prompt reimbursement of the contract costs so that funds may be used effectively in the interests of production.

2. Major divisions of audit.

The audit will consist of two major divisions:

a. A review of the contractor's internal procedures to determine their adequacy. If any deficiencies are disclosed, the contractor will be required to make the adjustments where practicable. If not practicable, the extent of the auditing will be increased accordingly.

b. An audit of the accounts and records to determine whether the recorded transactions are authentic, are properly recorded, and that the amounts claimed for reimbursement represent costs in accordance with the contract terms.

3. Purpose of manual.

a. The nature and extent of the audit and the applicable principles were covered in a directive issued 27 May 1942 by the Director, Fiscal Division, Headquarters, Services of Supply, approved by the Lieutenant General Commanding and the Under Secretary of War (see appendix). This manual provides instructions and supplementary information for the application of selective audit procedures in accordance with the principles set forth in that directive. The manual is designed primarily for plants having more than one CPFF contract, or having other work. In a plant devoted entirely to one CPFF contract, substantially all reimbursable expenditures will represent direct charges to the contract and will arise only from invoices and pay rolls. The sections of this manual devoted to journal entry procedures and to overhead costs will, therefore, usually not be applicable.

b. The manual also applies to so-called "cost service contracts" which cover the cost of mechanics and specialists who are servicing certain products supplied on other contracts, and to fixed-price contracts which contain a provision for reimbursement of tooling, training, or plant rearrangement on a cost basis.

4. Applicability to subcontracts.

The procedures described in this manual are applicable to cost-plus-a-fixed-fee subcontracts in the same manner as to cost-plus-a-fixed-fee prime contracts.

5. Allowability of costs.

a. Provisions of the contract which define cost must be carefully interpreted by the auditor. Many contracts incorporate Treasury Decision 5000 in the definition of cost and in that event the provisions of the latter document must likewise be studied.

b. The more complex matters of allowability are likely to occur in connection with costs classified as overhead or miscellaneous direct charges, rather than in direct material or labor. By eliminating unnecessary detailed checking, it is the purpose of this manual to provide more time for a careful review of such costs.

6. Cost Interpretations.

Cost Interpretations will be issued from time to time for the guidance of auditors and contracting officers in determining whether or not costs are allowable. They will be issued as chapter 5 of this manual.

7. Audit of overhead.

a. The effectiveness of the total audit depends upon an understanding of the relation of the audit of overhead to that of direct charges. Since overhead is made up largely of indirect materials and indirect labor, which differ from direct charges only in that they apply jointly to the contract and to other work, the same basic procedures which are applied to the audit of direct charges can be extended to include overhead. However, the audit of overhead requires one additional step—the determination of the equity of the methods and bases followed in proration.

b. It is important to emphasize that the detailed examination of individual overhead items is to be done currently. Floor checks and witnessing of pay-offs of indirect workers cannot be made on a post-audit basis. The checking of time tickets and requisitions becomes more difficult as time elapses.

c. The extent of the *detailed* examination of the indivdual items charged to overhead through the application of such checks will vary with the ratio of CPFF business to the total work done.

d. Where the CPFF business is small in proportion to the total, checks applied to overhead will ordinarily be less frequent. However, where the business, although small. is concentrated in certain departments, the more detailed examination of overhead items will be carried on currently in those departments along with the procedures involving direct charges. In any event, the *general review* of the overhead accounts and the *examination of methods and bases of proration* should be carried out regardless of the proportion of CPFF business.

8. Cooperation with property accountable officer.

When materials, supplies, and other property are purchased for use on the contract, the responsibility for the care and actual use of these items becomes that of the property accountable officer. The auditor, however, should cooperate with the latter officer in every practicable way in developing records and procedures by which the desired results can be obtained.

9. Relations with contractor.

a. Care should be taken to explain to the contractor the necessity for documentary and other auditing requirements and an effort should be made to enlist his full cooperation through a mutual understanding of the duties and responsibilities involved. The auditor also should cooperate with the contractor in showing him how to put his claims in proper form to expedite reimbursement. The auditor, however, should not prepare the Public Voucher, Form No. 1034.

b. Having agreed in his contract to keep an adequate accounting system, the contractor should be required to do so. At the same time, changes should be proposed by the auditor only when deficiencies clearly exist and after careful consideration and approval by higher authority. The effect of the proposed changes on the over-all cost of the work, including the contractor's personnel, must be kept in mind. Every effort should be made to obtain the contractor's approval and cooperation.

10. Performance of certain internal auditing functions by auditor.

a. In plants engaged solely on CPFF contracts a saving may be possible by having the

governmental audit staff perform part or all of certain internal auditing procedures of the contractor. Such a substitution is proper if it is *restricted to auditing operations*, and does not deal with the preparation of original records. However, it should be made clear that such an arrangement does not relieve the contractor of his responsibilities for developing accurate financial facts.

b. Each auditing program developed in accordance with the preceding paragraph should be approved by the fiscal branch of service or by the Budget and Fiscal Officer, Army Air Forces, before being put into operation.

11. Responsibility of contractor.

a. It is the responsibility of the contractor to submit claims for reimbursement excluding all costs expressly disallowed by the terms of the contractor. There should be no interference with the contractor's right to claim reimbursement for costs of doubtful allowability but there must be a full disclosure of facts at the time the claim is made.

b. In signing the "correct and just" certificate, the contractor is substantially in the same position as when he signs a Federal tax return. Heavy penalties are provided by law for false certification of facts in connection with all claims against the Government.

12. Need of alertness.

It is important that the auditor constantly seek out methods for achieving the objectives of his audit by more direct means. These possibilities will vary with the specific case. In addition, the auditor should always be alert to make his audit more effective by further inquiries and observations. The procedures set forth in this manual should be regarded as a general guide for the auditor to build a program which will achieve the desired results.

SECTION II

REIMBURSEMENT POLICIES

13. Reimbursement of costs.

a. It is intended that the contractor be reimbursed promptly and thus enable him to regain his capital for use in further production. Such prompt reimbursement also minimizes the need of the contractor for advances from the Government.

b. For the purpose of reimbursement, costs will normally be considered as expended when the currency has been paid out or the bank check drawn and placed in the mails. The reimbursement for overhead is, however, an exception to the general rule, as the overhead estimates used for current reimbursement include some items which are accrued but still unpaid.

c. As outlined in the sections dealing with overhead, the contractor is to be reimbursed for overhead each month on a tentative basis. These claims should be sufficiently less than the actual overhead applicable to the contract to provide a suitable margin of safety. However, care should be taken to avoid an excessive "hold back" of overhead during the year which would unnecessarily increase the contractor's capital requirements. Final settlements will be made at the close of each fiscal year of the contractor.

d. The total current reimbursements to the contractor for all costs are to be controlled to avoid exceeding the maximum total cost stated in the contract and amendments.

e. Contractors, engaged either solely on CPFF work or on CPFF and other work, may be reimbursed for pay rolls on a gross basis in respect to deductions for Social Security taxes, victory tax, and all other pay roll deductions. However, in respect to deductions for war bonds, the amounts deducted must be currently deposited in a special bank account to be used only for war bond purposes.

f. Unclaimed wages need not be deducted from pay roll claims filed until such wages have been unclaimed for 90 days.

g. It is acceptable procedure for telephone and telegraph expense in plants engaged on more than one CPFF contract, or on other work, to be reimbursed through overhead.

14. Payment of fees.

The contractor's fixed fee will be paid to him from time to time in accordance with the terms of the contract.

SECTION III

DOCUMENTARY EVIDENCE REQUIREMENTS OF GENERAL ACCOUNTING OFFICE

15. Introduction.

The documentary evidence requirements set forth in this chapter represent the *regular* requirements of the General Accounting Office,

and they apply whether the General Accounting Office audit is made at Washington or in the field. Other documents may, however, be required by the General Accounting Office when circumstances surrounding particular transactions indicate the necessity for further examination.

16. Original invoices for General Accounting Office.

a. General Accounting Office requires, as a general rule, the ribbon (first) copy of a *typewritten* invoice. When, in exceptional situations, for some valid reason the ribbon copy is not available, in lieu of it a *legible* carbon copy may be furnished, provided a representative of the contractor states in writing why the original cannot be furnished and certifies that it is the only copy which will be treated as an original and that steps have been taken to prevent duplicate payment. If the receipted "freight bill" is furnished, no certification is necessary.

b. It is not necessary for the vendor (or the contractor) manually to sign and certify as the original a copy of an invoice reproduced by a hectograph or similar process, but there should be a printed or other designation by the *vendor* that it is the original invoice. All purchase orders issued by the contractor after this date should require vendors using hectograph or similarly reproduced invoices clearly to identify *one* copy as the original. Invoices rendered under such purchase orders will not be acceptable unless these provisions are complied with.

17. Purchase orders and contracts.

a. Copies of all purchase orders will be furnished except for those under $5,000 *not* based on an oral or written bid. In the case of General Accounting Office field audits, copies of *all* purchase orders will be retained in the Government files.

b. If the contract requires the approval of purchase orders by the contracting officer, the approval must be indicated on any copy furnished to the General Accounting Office.

c. Purchase orders furnished must bear reference to the applicable War Department contract number. They are to be furnished to the General Accounting Office as soon as available instead of being attached to the Form No. 1034.

d. Where shipments are covered by a contract, the original of which has been furnished to the General Accounting Office, no copies of purchase orders are required covering individual shipments under such a contract.

e. If the purchase order, irrespective of amount, has been issued based on a formal or informal written bid, that original bid, together with the originals of any accepted amendments to it which change the net delivered unit price, are to be furnished. In the case of the General Accounting Office field audit, such original accepted bids and amendments will be retained in the Government files.

f. If no bid was obtained, the purchase order should so state. If oral bids were submitted, the purchase order should indicate "Oral bid of _____ date."

g. Correspondence referred to in the purchase order must be furnished.

18. Vendor invoices and credit memoranda.

a. The original itemized receipted invoice should be furnished or the check number by which the vendor's invoice was paid by the contractor is to be shown on the invoices or on copies of remittance statements to which they are attached.

b. Invoices or credit memoranda are to show the purchase order number. If they apply to a numbered agreement, the number must be shown on the invoice or credit memoranda.

19. Pay rolls.

a. If separate pay rolls are maintained for each contract, the original pay roll is required.

b. If separate pay rolls are *not* maintained, only pay roll summaries in reasonable detail for each contract are required showing at least the department names and total amount charged by departments. Such summaries are to be supported by a certificate of the auditor on Form No. 1035 as follows:

> I certify that the above amount determined by the contractor in its distribution of wages for the period indicated to be directly chargeable to the United States under the provisions of Contract No. _____ is true and correct and has been verified from the original records.
>
> _____
> Auditor

c. A definite showing is required that the contracting officer has reviewed all salaries and salary increases chargeable directly to the contract, and has taken any necessary action.

d. Each salary pay roll disbursed after 1 October 1942, *representing direct charges* to the contract and submitted in support of a Public Voucher, Form No. 1034, will bear the following certificate:

> This is to certify that this salary pay roll has been examined and the compensation, including increases in compensation, paid to the individuals has been approved.
>
> _____
> Contracting officer

e. If separate pay rolls are maintained for CPFF contracts, the deposit slips from the depositary designated by the Secretary of the Treasury covering pay roll withholding taxes should be obtained in duplicate, the original for the Internal Revenue Department and the duplicate copy to support the reimbursement voucher.

20. Travel expense reports.

a. The original reports are required showing employee's name, purpose of trip, points of travel, details of expenses or per diem rates in accordance with the terms of the contract, executive approval of the contractor, the employee's receipt if paid in cash or the check number if paid by check. If the number of travel reports is voluminous, the executive approval may be in the form of a summary certificate.

b. Whenever it is customary in regular business practice to issue receipts, they should be obtained and attached to the expense reports.

21. Petty cash disbursements.

a. Summary statements are required showing the date of expenditures, description of material or service, amount paid, and payee's name.

b. Each individual expenditure over $10 is to be supported by a receipt.

c. Each petty cash summary statement will bear the following certificate signed by an executive competent to approve the expenditures:

> The articles, commodities, or services procured for use of Contract No._____ and listed hereon after payment, were used in connection with the performance of the contract, and reimbursement therefor has not been previously claimed from the Government.
>
> *Contractor*
>
> By _____

22. Withdrawals from contractor owned stores.

A statement is required showing the price and amount of the individual items withdrawn. If, however, transactions are voluminous, a reasonably detailed summary by classes and types of material is sufficient.

23. Tool and other work orders.

A statement is required listing the work orders in reasonable detail and showing material cost, labor cost, and applicable overhead.

24. Overhead.

a. Claims for reimbursement of overhead are to be supported by statements detailing the major elements included and showing the method of apportionment. If departmental rates are used, departmental analyses are to be submitted. Detailed statements are necessary only in support of the first reimbursement claim and claims which involve changes in rates. On other vouchers appropriate cross-reference should be made to the voucher which carries the applicable detailed statement.

b. The contractor will append the following certificate to each reimbursement claim:

> I certify that the amounts claimed as progress payments on account of overhead expense are less than the estimated amounts properly chargeable to the contract on that account.
>
> *Contractor*
>
> _____
> (Title)

25. Operation of cafeterias, commissaries, etc., in plants engaged solely on CPFF contracts.

a. If a special working or imprest fund has been set aside to finance the operation of the cafeteria or similar facility, the contractor will submit, not less than once each 4 weeks, a statement of operations for the period certified by the contractor as correct. The fund may

be reimbursed for losses, or the profits may be applied against reimbursement vouchers on the basis of this statement, and no further supporting documents will be required.

b. If such a working fund has not been established, it will be necessary to furnish all original invoices, pay rolls, etc., in support of the disbursements and receipts.

26. Corrected invoices.

a. Invoices will not be acceptable when the amount has been increased to correct for errors, greater quantities actually delivered, etc., unless such correction is instituted and approved by the claimant. Minor reductions in the amounts of invoices, however, will be acceptable when made to correct errors evident on the face of the invoice.

b. A corrected invoice will be acceptable, if the invoice first submitted is attached to it with appropriate cross-reference and explanation is made on both invoices. However, if the contractor returns the original invoice to the vendor for adjustment, and the vendor resubmits only a corrected invoice, the contractor should certify on the corrected invoice:

> I hereby certify that the original invoice was returned to the vendor for adjustment. This corrected copy is to be considered as the original and only invoice covering this material, and will not be paid twice.
>
> ---
> Contractor
>
> By ---

27. Telegraph charges.

a. When telegraph charges are reimbursed as direct charges, an original and two copies of invoices covering telegraph services is the maximum number that will be required from the *telegraph company* in any one case for governmental purposes. Any additional copies required by the contractor will be prepared by him. Distribution will be as follows:

> Original—attached to the original of Form No. 1034 for General Accounting Office.
>
> One copy—attached to Form No. 1034a for finance officer.
>
> One copy—attached to Form No. 1034a for auditor's files.

b. When the General Accounting Office is auditing vouchers currently at the project, only the original invoice is required. This will be attached to the auditor's copy of the voucher.

c. The original invoice attached to Form No. 1034 for the General Accounting Office will be supported by one copy of each telegram, and no other copies will be required for governmental purposes. Where practicable, this copy will be supplied by the telegraph company. Where the General Accounting Office is auditing invoices currently at the project, the single copy of each telegram will be retained in the auditor's file. If the General Accounting Office is not auditing currently at the project, the auditor will not retain copies of telegrams in his files.

d. Pursuant to the provisions of Public Law 4, 78th Congress, approved 6 March 1943, cost-plus-a-fixed-fee contractors and subcontractors may no longer send telegraph, cable, or radio messages at Government rates. Effective 6 March 1943, commercial rates therefor will apply to all messages sent by CPFF contractors and subcontractors.

28. Evidence of payment.

a. A form, "Certificate of Evidence of Payment" (see illustration below), will be executed by field auditors or resident auditors coincident with each reconciliation of a bank account of a contractor, whether monthly or more frequently, observing the following procedures:

(1) All original purchase invoices, original (separate) pay rolls, and other documents submitted with public vouchers in support of *direct charges* to the contract and represented by current *check* payments by the *contractor* are to show, either on the documents themselves or on attached remittance advices, the check numbers issued in payment. If the checks are entered in a solid numbered series on a pay roll sheet, only the beginning and ending check numbers are required.

(2) When all of the checks listed by number on the applicable vouchers have been cleared by the bank as determined at the time of reconciliation of the account, the auditor will list

such vouchers in the "Certificate of Evidence of Payment," and execute the certificate in duplicate, sending the original to the Audit Division, General Accounting Office.

(3) When a check has been lost before clearance by the bank and a replacement check is issued, the voucher will not be listed until the replacement check has cleared.

(4) If any check is not cleared within a maximum period of 90 days from date of issuance, an appropriate deduction will be made from the next available voucher. The voucher on which the check was originally listed may then be included, if all other checks are cleared, in the "Certificate of Evidence of Payment" with a suitable notation indicating the check numbers and amounts which have been deducted from other vouchers, and the date and voucher number from which the deduction was made.

b. The above procedures are applicable regardless of whether the General Accounting Office audit is conducted in Washington or in the field.

CERTIFICATE OF EVIDENCE OF PAYMENT

Audit Division
General Accounting Office

Contractor ---

Contract No. ---

I certify that all checks issued by the subject contractor which are listed on documents supporting the public vouchers shown below have been audited by a Government representative, and that payment is evidenced by paid checks cleared through the contractor's bank account.

(Title)

Date ---

Date of voucher	Bureau number	D. O. number	Amount of voucher

29. Special clothing and equipment purchased for operation of contract.

In cases where reimbursement is claimed for special clothing, boots, metal gloves, equipment, etc., deemed necessary for the operation of a contract, each voucher covering reimbursements for such items should be supported by a certificate in the following form:

> I hereby certify that the ---- for which payment is made on this voucher were deemed necessary for the operation of the contract. In accordance with the company's general policy, the above items were issued to employees without charge for use while on duty and remain the property of the Government.
>
> ---
> Contracting officer

30. Disposition of vouchers and supporting papers in War Department audit files at field projects.

a. When a cost-plus-a-fixed-fee supply contract is terminated, either at the option of the Government or because of the completion of the contract, it will be necessary to make proper disposition of the vouchers and supporting papers which have been held in the files of the War Department auditor.

b. In cases where the General Accounting Office audit has been made in Washington, the files maintained by the War Deparment auditor will be disposed of in accordance with instructions issued by the individual technical services or the Army Air Forces.

c. In cases where the General Accounting Office audit is performed in the field and the contract has been completed, the vouchers and supporting documents, when not required for Government purposes at the project, will be forwarded to the Reconciliation and Clearance Division, General Accounting Office, Washington 25, D. C. In such cases the particular documents to be sent will be designated by the field representatives of the General Accounting Office under the supervision of the chief cost auditor or the auditor in charge of the particular area station involved. To facilitate the handling and filing of the documents, the vouchers should be arranged in numerical order by D. O. voucher number under the name of each disbursing officer, and the contents of each box or package should bear a label indicating the contract symbol number or the contract to which the vouchers and supporting documents pertain.

CHAPTER 2

REVIEW AND APPRAISAL OF CONTRACTOR'S PROCEDURES

SECTION I

GENERAL SURVEY

31. Purpose.

a. As one of the initial phases of his work the auditor should make a general survey of the contractor's organization, plant, products, and processes.

b. The purpose of the survey is to furnish a background of essential information so that an audit program can be intelligently formulated and effectively carried out. This background is particularly important in the appraisal of the contractor's methods of prorating overhead. The audit contemplated in this manual emphasizes the constant exercise of judgment in deciding, subject to procedures established by this manual, how much work is to be done, where it is to be directed, and how much reliance is to be placed upon the contractor's records and internal control procedures. Such decisions require a general familiarity and informed contact with actual operations and physical property. While the auditor necessarily devotes most of his time to the records, there must be sufficient contact with these activities so that the examination of records is not merely a mechanical process but is related to what is actually happening.

32. Scope.

a. So far as practicable, the survey should involve first-hand observation by the auditor. These observations should be supplemented by information furnished by the contractor, submitted in form suitable for filing as part of the survey record. The survey should be made with the active cooperation of the contractor and in the spirit of gathering general information without an independent verification of the facts at this stage.

b. The main lines of inquiry hereafter enumerated are not necessarily separate and distinct. For example, the product manufactured will be observed at the same time the plant and equipment are being inspected.

c. The general survey should include the following:

(1) *Organization.* The general structure of the organization in the manufacturing and administrative divisions. An organization chart should preferably be obtained prior to the inspection of the plant.

(2) *Financial policies.* The auditor should familiarize himself with the contractor's financial policies, including the financing of the operation of the contract and the acquisition of the necessary facilities. Copies of current financial statements should also be obtained.

(3) *Plant and equipment.* Inspection of the complete physical lay-out of the plant; the location of departments and types of equipment used in the production and service departments.

(4) *Products.* The auditor should familiarize himself with the general specifications of the products manufactured, the general appearance and the materials used, what parts and subassemblies are manufactured and what purchased. As soon as possible a copy of the bill of material should be obtained for reference purposes.

(5) *Processes.* Observation of the manufacturing processes, the storage and handling of materials, accumulation and disposition of scrap, and the flow of production through the plant.

SECTION II

ACCOUNTING POLICIES OF CONTRACTOR

33. Introduction.

Before proceeding with the review of the system of internal control, the auditor should obtain a written statement from the contractor setting forth his accounting policies. Through this statement the accounting policies may be appraised and questions of allowability determined on the basis of broad policy. Such a statement is essential to the review and evaluation of the contractor's internal control and for the determination of the allowability of costs through the application of auditing procedures. The statement of accounting policies required under this section is not to be confused with a description of the accounting system such as is dealt with in sections IV to VIII, inclusive.

34. Consistency in application.

The contractor's accounting policies as stated should be followed consistently throughout the contract period. When acceptable policies have been in effect in prior years, the same policies should be continued.

35. Adjustment of deficiencies in accounting policies.

In correcting deficiencies in accounting policies, it may be necessary to adjust certain asset or liability accounts at the beginning of the contract period to reflect proper current charges to the contract for items such as supplies used, property taxes, etc.

36. Revision of chart of accounts.

The contractor's classification of accounts should be revised to provide for the segregation of all items of expense not allowable as costs under the terms of the contract.

37. Scope.

a. The statement of accounting policies should cover all matters applicable to the particular contractor. The following, however, usually are to be included:

(1) *Inventory policies.* (*a*) Classes of materials and supplies inventories, how frequently inventories are taken, and the basis of pricing.

(*b*) To what accounts the adjustments of book inventories to physical are charged or credited.

(2) *Permanent assets.* (*a*) *General.* A general statement of the bases followed in determining the carrying amounts on the books, or the amounts to which depreciation rates are applied if the book basis is not used.

(*b*) *Additions.*

1. Policies for distinguishing between charges to asset accounts or to repairs and maintenance—type, length of life, unit dollar amount, etc.
2. Treatment of transportation and installation costs of new equipment.
3. Allocation of overhead to items constructed by contractor for own use.

(*c*) *Disposition.*

1. How are retirements or sales reported.
2. How handled in accounts and where resulting loss or gain is charged or credited.

(*d*) *Depreciation.*

1. How rates are determined.
2. Application of rates to original cost or depreciated balance.
3. When is depreciation started on new additions—month in which addition is made, middle of year, first of following year, etc.

(3) *Deferred charges.* (*a*) Types of items deferred.

(*b*) Basis of write-off.

(4) *Accruals.* (*a*) Types of items accrued.

(*b*) Bases of accrual.

(5) *Personnel relations.* Accounting policies based on administrative policies in respect to—

(*a*) Overtime payments—hourly and salaried employees.

(*b*) Group and other insurance.

(*c*) Vacations and sick leave.

(*d*) Bonuses.

(*e*) Christmas gifts.

(*f*) Pensions.

(6) *Application of overhead.* (*a*) *Types of* charges ordinarily included in overhead but which are to be charged directly to the contract on some basis of specific allocation.

(*b*) The propriety of the bases of overhead apportionment should be justified.

(*c*) If one over-all manufacturing rate is used instead of departmental rates, such a basis should be justified.

(*d*) If departmental factory rates are used, the bases of proration of the expense of all service and general departments to direct depart-

ments or burden centers should be clearly set forth and justified.

(7) *Miscellaneous.* (*a*) Reserves for self-insurance.

(*b*) Explanations of differences in policies followed in the preparation of tax returns and those reflected in the books.

(*c*) Basis of pricing for interplant or interdivisional charges for materials and services.

(*d*) Treatment of scrap.

(*e*) Policies for reimbursement of employees for travel expense.

(*f*) Treatment of miscellaneous revenue such as rental income, cash discounts on items charged to overhead, sale of waste paper, vending machine income, general unclaimed wages, etc.

(*g*) Any other matters existing in the case of the particular contractor which involve to a substantial extent the costs or revenues applicable to the contract.

SECTION III

GENERAL NATURE OF INTERNAL CONTROL

38. Introduction.

a. The scope of the program of audit for a CPFF contract depends to a major extent on the contractor's system of internal control. The arrangement of internal procedures and creation of cross checks between individuals and activities provide the assurance that the accounting results are developed accurately, and it is this assurance which largely eliminates the necessity for duplicating the work of the contractor. The auditor should therefore study and appraise the system of internal control in the particular contractor's organization.

b. To do this efficiently the auditor first should understand the meaning of internal control and the principles which relate to it. Second, he should have a plan by which he can review the particular system of internal control and dedetermine its effectiveness. He then is able, through the exercise of judgment, to determine the nature and scope of his audit program.

c. It is the purpose of the present chapter to discuss the nature of internal control and the general principles involved. The chapters following will deal with the actual review of internal control.

39. Scope of internal control.

Broadly speaking, internal control refers to the effectiveness of all of the internal procedures of an accounting and general financial nature. It includes both the procedures constituting the accounting system and also such internal auditing as may be carried on by the contractor. It is not restricted to procedures solely of a bookkeeping nature. Instead, internal control should be viewed as including all of the contractor's procedures having to do with the accuracy and general reliability of quantities or dollars as developed in the various forms and records.

40. Basic principles of internal control.

a. Checks and Balances. (1) A basic principle of all internal control is the application of checks and balances. Two or more procedures are developed along different lines or carried on by separate persons or groups of persons. The result developed by each procedure then provides a check or basis of appraisal against the other. The effectiveness of the cross check is in proportion to the degree of independence existing between the two procedures. It also follows that the greater the volume of transactions the greater the possibilities of developing the number and effectiveness of such checks.

(2) The system of checks and balances can be applied in many ways. In one of its more elementary and routine phases it may involve two operations of a single individual. Its greater effectiveness, however, comes when two or more individuals are involved in the operation, as for example, when one person prepares a voucher and a second person makes a comparison of it with the underlying papers. If the second individual obtains the information from a different source and uses this as a basis for the second check, then the cross check is made still more effective. At a still higher level the work of one department provides a check against the work of another department, as for example, where the distribution of the pay roll made by the cost accounting department is checked against the figures developed for payment purposes by the pay roll department. The term "check" is not limited to the fact of mathematical agreement; it may refer also to qualitative checks. The

quality of the materials purchased by the purchasing department and inspected by the inspection department is, for example, subjected to a secondary check when put into production in that if rejections are frequent because of defective material a general protest from the production department will be forthcoming.

b. No Person in Complete Control of Important Part of Transaction. The desirability of checks and balances is commonly expressed as a principle that no one person should be in entire control of an important part of a business transaction. Where such is the case the possibilities of fraud, carelessness, and errors in general are greatly increased. When the work of one person is subjected to review by a second under the normal routines, there is added assurance of accuracy up to that point. There is also greater probability that the first employee will function more efficiently when he knows that his work will be subject to review.

c. Accounting and Operation Should Be Separated. The same plan of checks and balances is again often expressed in the special principle that accounting and operation should be separated. For example, a storekeeper should not be permitted to establish without control his own accountability for materials. Similarly a cashier should not receive cash and also work on or have access to ledgers or books of original entry other than those recording cash receipts. Such a situation might make it possible to manipulate the records to cover up the misappropriation of assets.

d. Responsibilities Should Be Fixed to Greatest Practicable Extent. Another important principle of internal control is that, so far as is practicable, responsibilities should be clearly fixed. In certain situations, as for example, in the case of cash, equipment, and the like, the responsibilities can be fixed in terms of definite accountabilities. In other situations the responsibility is of a more general nature, such as the responsibility for making purchases. In all cases, however, the more precisely the responsibility can be fixed, the greater likelihood there is that personnel will function in an efficient and trustworthy manner and that fraud and error will be minimized.

41. Utilization of physical checks.

The effectiveness of the accounting control depends to a major extent on the utilization of physical checks. It is important, therefore, that such checks be employed to the maximum extent practicable. For example, book inventory records should be checked at periodic intervals with physical inventories so that errors may be eliminated in the early stages and appropriate adjustments made.

42. Collusion.

The auditor should realize that no system of internal control is infallible and he must be constantly alert for possible collusion and other conditions which may lessen the effectiveness of particular phases of the accounting control. The system of internal control should be designed to make collusion difficult.

43. Contractor's internal auditing program.

a. The internal auditing program, when carried on by persons independent of the regular accounting procedures, represents an important means of improving and maintaining the system of internal control. Its function is to maintain a continuous check on the operation of the accounting and financial procedures.

b. Where such a program is carried out by the contractor, it should be given weight in determining the reliance to be placed on the system of internal control. It does not follow, however, that a contractor who does not have a separate internal auditing department cannot have a sufficiently adequate system of internal control to justify selective audit procedures.

44. Definition of "independent person."

In describing good internal procedures the term "independent person" frequently is used. It must be recognized that the status of such a person will vary depending on the particular circumstances. The independent person, however, should be at least one who is not subject to the same immediate superior as the person or operation with respect to which it is desired to establish independence, and he should not participate in the operation involved.

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SECTION IV

OUTLINE OF PROCEDURE FOR REVIEW AND APPRAISAL OF INTERNAL CONTROL

45. Nature of review.

a. The importance of the internal procedures of the contractor's organization in providing a reliable record of accounting data can hardly be overemphasized. It is essential that the auditor investigate the operation of the internal procedures and challenge them at every point. He must realize that procedures are often established which appear to be adequate but which in practice are either never carried out or gradually break down over a period of time. The human element is always to be considered, and the auditor must therefore determine first hand that given procedures are actually carried out.

b. The review of the internal control procedures should be made as the initial phase of the audit in order that the results obtained can provide a basis for developing the actual audit program.

46. Getting facts regarding system.

Memoranda should be prepared by the auditor, with such assistance from the contractor as is practicable, describing the important aspects of the contractor's internal procedures. Each of the various paragraphs as described in Sections V to VIII, inclusive, of this chapter will be covered in a separate memorandum and will deal with the handling of important accounting matters. These memoranda will include organization charts, names of persons responsible, approvals required, etc., and will give particular attention to controls or checks which tend to assure an accurate and reliable record. When completed in proper form they set forth the contractor's representations as to his system of internal control, and will become part of the auditor's working papers.

47. Determining how system works in practice.

The auditor then should determine the extent to which actual practice conforms to the procedures stated to be in effect. This should be done by inquiries directed to the persons who are charged with carrying out the procedures and by actual observation of the manner in which the transactions are handled. In this phase of the review the auditor should set forth in his working papers the nature of his inquiries and observations and the findings made, following the same outline as used in the memoranda covering the procedure stated to be in effect.

48. Appraisal of system of internal control.

a. With the above facts regarding the procedures being followed, the auditor is in a position to appraise the adequacy of the internal control. For this purpose he should use the guides set forth in Sections V to VIII, inclusive. The working papers should indicate the extent to which the given system varies from the preferred procedures and should set forth the auditor's opinion of the adequacy of the internal control resulting from the procedures actualy being followed.

b. Where, in the judgment of the auditor, the contractor's internal procedures as to a particular phase are not adequate, the contractor should correct the deficiency. If, in unusual cases, such changes are not practicable, the auditor will extend his audit procedures as to that phase to the extent required to protect the interests of the Government. The auditor's decisions relative to the above questions will be recorded in the working papers and before action is taken will be referred to higher authority for approval in accordance with the standard procedure of the service involved.

SECTION V

INVOICES

49. Introduction.

This section is applicable to invoices charged directly to the contract or to overhead accounts, stores, property, or other accounts which ultimately may affect the cost of the contract. The procedures set forth are those which the contractor preferably should follow, and are to serve as a guide for the auditor's review and appraisal of the procedures actually in effect.

50. Purchasing.

a. Procedures should be in effect to avoid purchases of materials in excess of the contract requirements.

b. All commitments for materials and services, including utilities services, should be covered by written agreements or formal purchase orders, except for professional services such as legal, accounting, and medical.

c. Purchase orders should be complete and definite as to specifications and quantities of material, description of services, prices, discounts, transportation terms, F. O. B. point, delivery schedule, and terms of payment. They should be approved by a responsible executive of the contractor and, when required under the contract, by the contracting officer.

d. The purchase order should bear the number of the contract to which it applies.

e. Where the nature of the material is such that the trade practice is to permit some variation between the quantity ordered and the quantity shipped, the purchase order should specify the maximum plus or minus variation.

f. Changes in quantities, specifications, terms, etc., agreed to after issuance of the original order, should be covered by approved change orders.

g. Wherever possible, purchases applicable to CPFF contracts should be made free of sales or use taxes.

h. Transportation bills should be checked against the applicable purchase order, cross-referenced thereto, and be approved by qualified personnel. They should also be checked against invoices directly or through data posted on the purchase order.

51. Receipt of materials or services.

a. Receiving reports, covering both direct and indirect materials, should be prepared by receiving department personnel who are independent of employees in the purchasing department, and in the case of direct charges to the contract, should be approved by a Government representative as to quantities.

b. Procedures should be in effect to assure that all contractor and Government inspection reports are being reviewed for rejections and that appropriate charges are made against vendors.

c. Wherever practicable, materials, after receipt in a receiving department, should be delivered to a storeroom and cleared through the stores record.

d. Invoices for utility services should be checked through independent meter readings, records of telephone calls, and other data.

52. Recording of materials in stores records.

The control of materials after purchase is not directly a part of the purchase invoice procedures. However, stores control through inventory records provides a useful check on the actual receipt of the material and the accuracy of the accounting distribution. It is therefore an important internal control procedure and should be utilized. Stores control will be further treated in section VII.

53. Invoice payment procedure.

a. Vendors' invoices should be checked by independent persons with related purchase orders and receiving reports.

b. Where more than one invoice applies to a single purchase order, information should be shown on the purchase order giving the shipments to date and the balance to be billed.

c. All invoice additions, extensions, and deductions should be checked.

d. Special care should be exercised that debit memoranda for all shortages, overpricing, and the like are deducted from invoices of the vendor.

e. All debit and credit memoranda should be cross-referenced to the applicable invoices.

f. The deduction of all cash and trade discounts, rebates, freight allowances, and quantity discounts should receive particular attention.

g. Invoices for outside services not supported by receiving reports should be approved by a qualified executive.

h. When invoices are ready to be paid, qualified independent personnel should review their validity and the accuracy of the accounting distribution. All unallowable costs should be eliminated from charges directly or indirectly affecting the contract.

i. Payment should be approved by an independent financial executive.

54. Invoices for communication charges.

a. When telegraph charges are handled as direct charges to each contract, the following procedures should be applied:

(1) Procedures should provide for showing the contract number on all telegrams directly

chargeable to a contract at the time of transmission, so that the telegraph company can bill the charges separately for each contract. Federal tax exemption certificates should also be filed.

(2) When the invoice is received from the telegraph company covering telegrams directly chargeable to the contract, the contractor, after satisfying himself as to the applicability of the messages to the contract, should execute the following certificate on the auditor's copy of the invoice.

> I certify that the messages which are listed on the attached invoice totaling $____ are properly chargeable to the contract.
>
> *Contractor*
>
> By_____
> (Title)

b. When telegraph charges are handled through overhead, the procedures for computing tax exemption outlined in *d* below for telephone expense will be applicable to telegram expense.

c. Where telephone toll and long distance charges are handled as direct charges to each contract, satisfactory records should be maintained for the identification of such calls and Federal tax exemption certificates should be filed.

d. Where telephone toll and long distance charges are handled through overhead, the following procedures should be applied:

(1) The amount of the tax exemption should be determined by applying to the total tax billed the ratio between the telephone expense charged to the contract and the total of all telephone expense. For example, if through the regular prorations of overhead the portion of total telephone expense charged to the contract is 70 percent, then 70 percent of the total tax billed is to be claimed as exempt and one tax exemption certificate filed therefor.

(2) At the time the telephone bill is prepared for payment, the ratio specified in (1) above, for the period covered by the bill, may not be known. In such cases the ratio for the previous month may be used if it is considered to be reasonably applicable Care should be exercised over the period of the contract that the method followed results in an equitable determination of the tax exemption.

(3) The gross amount of the telephone bills, including the total tax billed, should be charged to overhead. The amount of the exemption should be deducted from the telephone company's bill and credited to a separate account. The latter credit should then be deducted from the contractor's overhead claim after that claim has been calculated without benefit of the tax exemption.

55. Invoices from CPFF subcontractors.

CPFF subcontractors should submit to the prime contractor their commercial invoices for reimbursable costs. Such invoices should be subjected to the same internal procedures as other purchase invoices.

56. Invoices from "time and material" vendors.

When purchase orders are issued for outside work on the basis of actual hours expended, to be billed at an agreed rate, the hours billed should be audited by the contractor. If material is furnished by the vendor, charges therefor will also be subject to audit.

57. Travel expense reports.

a. Procedures should be in effect for executive control over travel expense advances and for accounting controls to insure that the balances are cleared only through a proper expense report or refund of the balance of the advance. A claim for reimbursement can be made only after the travel has been completed and the contractor's procedures should recognize this requirement.

b. The procedures should provide for the submission of expense reports in accordance with the requirements listed in paragraph 20 in respect to documentary evidence.

c. In preparing claims for reimbursement, procedures should provide for excluding items such as entertainment, subsistence in excess of established limits, etc., which are not in accordance with the terms of the contract.

d. The contractor should require receipted bills in support of expenses claimed by the traveler whenever it is customary in regular business practice to issue receipts.

e. Care should be exercised that tax exemptions are obtained covering Federal taxes on all transportation tickets.

58. Petty cash disbursements.

a. The procedures should provide restrictions on the size and type of individual disbursements.

b. It is not desirable to make pay roll disbursements out of petty cash. These payments should be made either by drawing a pay roll check or from the paymaster's funds.

c. Rules for writing the petty cash voucher in ink or otherwise protecting against alteration should be enforced. The receipt of the payee and the written approval of an authorized executive should be obtained.

d. When a reimbursement check is drawn, the supporting documentary evidence should be reviewed by a responsible employee for validity, accuracy and correctness of distribution. The individual vouchers should be stamped or otherwise adequately canceled, but not destroyed.

59. Interplant or interdivisional charges.

When work applicable to the contract is done in other plants or manufacturing divisions of the contractor in which separate books are maintained, interplant billings will be required. At the originating plant the invoices should be submitted to the Government auditor for audit and at the main plant they should be subjected to the same internal procedures as invoices from outside vendors and subcontractors.

60. Credits.

Where a credit adjustment is covered by a credit memorandum or by a remittance from the vendor, controls should be maintained to assure that proper credit is made to the cost of the contract. Such controls should include requirements that all materials or other property leaving the plant be covered by authorized shipping orders.

SECTION VI
PAY ROLLS

61. Introduction.

a. This section is applicable to pay roll disbursements charged directly to the contract or to overhead accounts, work orders, or other accounts which may ultimately affect the cost of the contract. The procedures set forth are those which the contractor preferably should follow and they are to serve as a guide for the auditor's review of the procedures actually in effect.

b. Inasmuch as the procedures having to do with hourly rate or factory pay rolls are different in many respects from salary pay roll procedures, the two types will be treated separately.

HOURLY RATE PAY ROLLS

62. Personnel records and procedure.

a. The hiring and dismissal of all hourly rate employees preferably should be cleared through a responsible individual or a centralized personnel department for the purpose of maintaining adequate personnel records.

b. Adequate records should be set up at the time of employment covering the employee's personal data, the rate, and other terms of his employment. These records should be maintained independently of the pay roll department.

c. The pay roll department should add names to the roll only on the basis of written advice from the executive responsible for the personnel records.

d. Rigidly enforced procedures should be established for immediately reporting to the pay roll department the dismissals or other separations of employees from the pay roll.

63. Timekeeping.

a. The preparation of the basic attendance record—usually time clock cards—should be properly safeguarded through adequate supervision by independent persons.

b. The attendance clock card, or similar record, will normally become the basic record for computing the earnings of the employee. In some plants it is feasible also to use the card for distribution purposes, although commonly a separate record is prepared.

c. The distribution tickets, or other record of worker's performance, should preferably be prepared by a timekeeper, but if prepared by the workman, time checkers should make floor checks to check the accuracy of the distribu-

tion. In large plants, particularly where the men are changing jobs frequently, it is not practicable to have the foreman make out the distribution record.

d. The distribution record (time tickets or job cards) should be reconciled daily in the factory, by independent persons, with the hours shown by the attendance clock record.

e. Where the employees are paid on a piece work or other incentive basis, controls should be maintained by having independent persons perform operations such as—

(1) Checking production counts.
(2) Approving allowances for nonstandard conditions (e. g., shortages of materials or tools and delays due to machine break-downs).
(3) Written authorization of piece rates or labor standards.

f. Persons having any part in the preparation of records which become the basis for payment of employees should have no responsiblity for the pay-off.

64. Accounting distribution.

a. The summarizing of the distribution records of charges directly to particular contracts, work orders, or to overhead classifications should be independently checked to detect erroneous sorting of tickets or errors in placing the contract numbers on tickets.

b. The summaries of pay roll distribution should preferably be made in a department other than the pay roll department, such as the cost department, and should be reconciled with the total pay rolls.

c. Procedures should be in effect for excluding from amounts claimed as reimbursable, either as direct charges or as part of overhead, any items which are not applicable to the contract.

65. Preparing pay roll.

a. The individuals preparing the pay roll should have no part in the preparation of the basic time records, the time checking, or the actual pay-off.

b. All rates in effect should be supported by proper written authority.

c. Systematic routines should be maintained by the contractor to insure that proper deductions are made from wages.

d. Suitable cross checks should be maintained within the pay roll department with respect to the accuracy of hours, rates, extensions, and footings.

66. Making pay roll disbursements.

a. The distribution of the checks or cash to employees should be under the charge of persons independent of the timekeeping, time checking, and pay roll preparation.

b. Preferably, signed receipts should be obtained if payment is made in cash.

c. At the time of pay-off neither checks nor cash should be given to other than the worker. Unclaimed wages should immediately be placed under the control of an independent responsible person and given to other persons only on a properly authenticated written order.

67. Interim pay-offs.

Pay-offs of employees between regular pay days should be recorded on pay roll records in the same manner as the regular pay roll and included in the distribution of the pay period to which they apply. It is not good procedure to make the accounting distribution of such pay-offs directly from the cash disbursements records.

68. General.

The contractor's procedures should provide for continuous control over labor costs by which variations and trends in costs are studied and investigated currently. Such control may be through the use of labor standards set by time studies or by comparison with costs of previous periods or lots.

SALARY PAY ROLLS

69. Personnel records.

Records should be available showing approvals of the engagement of salaried employees and their salary rates.

70. Timekeeping.

It is a common and desirable practice to require the ringing of an attendance clock card or other evidence of attendance by all or most salaried employees.

71. Preparing pay roll.

a. The pay roll, including both regular and overtime payments, should be approved in writing by one or more responsible executives.

b. Procedures should be maintained to insure that all proper deductions are made.

c. Suitable cross-checks should be maintained as to accuracy.

72. Accounting distribution.

a. The procedures should provide for a careful review of the salary pay roll distribution to eliminate from charges to the contract, either directly or through overhead, the salaries of any individuals whose services are not incident to and necessary for the performance of the contract.

b. All distributions should be approved by a responsible executive.

ALL PAY ROLLS

73. Limitations on pay rolls.

The contractor's procedures should provide for compliance with contract and administrative limitations on total compensation allowable for personal services.

74. War savings bonds and stamps.

a. Before deduction for war savings bonds and stamps can be made from wages, each contractor's employee shall sign a pay roll War Savings Authorization Card (DDS 232 Revised).

b. The contractor's pay roll should show the amount deducted for purchases of war savings bonds and/or stamps and should contain a statement by the contracting officer, or his authorized representative, that deposit of the deductions has been verified.

c. The total withheld from employees will be deposited immediately with a bank insured by the Federal Deposit Insurance Corporation in a separate account so designated as to indicate its special character and purpose. It is not necessary to use a separate account for each contract.

d. Withdrawals from such accounts shall be only for the purpose of purchasing war savings bonds and/or stamps for delivery to employees or for refunding employees payments on subscriptions. Refunds may be made by a check drawn on the special war bond account or the contractor's regular bank accounts. In the latter case, the contractor will reimburse his regular account from the special war bond account.

e. The contractor will maintain appropriate records of all transactions involving employee's subscriptions including a periodic reconcilement of the total amount of employees' payments on unissued bonds with the balances in the special bank account.

SECTION VIII

JOURNAL ENTRIES

75. Introduction.

a. The internal procedures under invoices and pay rolls have dealt with items involving cash disbursements, many of which involve direct charges for which reimbursement can be immediately claimed. Other cash expenditures are made for overhead items, and reimbursement for these will usually be claimed through tentative monthly rates. Also, many cash expenditures affect stores accounts, deferred charges, property, and the like, in which case journal entries must provide for the distribution or write-offs from these accounts. If such journal entries result in direct contract charges, reimbursement can then be claimed. For the most part, however, the journal entries will involve items which will be reimbursed as a part of overhead.

b. The internal procedures under review in this section are those which deal with the validity and accuracy of these intermediate distributions and allocations so that when reimbursement for overhead is claimed the reliability of the content of the overhead will have been established.

c. The procedures following are those which the contractor preferably should follow and serve as a guide for the auditor's review of the procedures actually in effect.

76. Materials and supplies from contractor-owned stores.

a. A dollar control should be maintained over materials and supplies owned by the contractor which subsequently may be issued directly for contract use or chargeable to overhead.

b. Contractor-owned and Government-owned materials and supplies should be physically segregated and separately controlled. Requisitions from Government-owned stores should be of a distinctive color or otherwise distinguished to avoid possible confusion with requisitions covering contractor-owned materials.

c. All materials drawn from contractor-owned stores should be on a standard requisition form approved by a responsible employee and preferably showing evidence of receipt by the using department.

d. Cross checks should be maintained to insure the accuracy of clerical computations, distributions of charges, and development of summaries.

e. The contractor's procedures should provide for current checking of physical quantities against the book records.

77. Work order charges.

Some contractors issue work orders to collect the costs of tools, major repair jobs, rearrangement of equipment, etc. Such work orders may serve as suspense accounts to be cleared eventually to overhead or other accounts. The charges thereto come from stores, invoices, and pay roll but the procedures of issuing and controlling work orders require separate review.

a. Work orders should be numbered serially and issued only by authorized executives competent to determine the necessity for the work and the propriety of the proposed accounting distribution.

b. Work orders chargeable directly to the contract or to overhead should be cleared at least monthly to avoid an undue accumulation of undistributed costs.

c. Work orders cleared should be checked for accuracy of computations and distribution by competent independent persons. Summaries should be subjected to similar checks.

78. Write-off of deferred charges.

a. Write-offs should be checked as to computations, allocations, and conformance with established policies.

b. The accounting distribution of the write-off should be approved by a responsible executive.

79. Depreciation.

a. Additions or betterments to property, plant, and equipment should be approved by responsible executives both before the acquisition, and later as to proper receipt of items involved and propriety of charges.

b. Procedures should be in operation to insure that retirements of all kinds are promptly reported and that the accounting clearances are accurately made.

c. Appropriate checks should be in effect with respect to depreciation charges, as follows:
(1) That rates are used in accordance with established policies.
(2) That rates are applied to a proper depreciable basis.
(3) That computations are accurate.

d. The accounting distribution of the depreciation charges should be reviewed and approved by a responsible executive.

80. Accruals of expenses.

Appropriate checks should be in effect as to accuracy of calculation and distribution and conformance with established policies.

APPLICATION OF OVERHEAD

81. Introduction.

a. Overhead may be described as those expenses or proportions of expenses pertaining to the contracts which have not been dealt with as direct charges. Such overhead will usually be divided into classes and different basis for allocation of the various classes of allowable overhead will usually be acceptable.

b. It is important to note the difference in the basis for reimbursement of overhead as compared with direct charges. As to the latter, the basis for the most part is payment by the contractor as a prerequisite to reimbursement. Since it is impracticable to recompute the overhead on a cash disbursement basis, the accrual basis may be used, with the understanding that all items which have been treated as expenses either by accruals or by setting up of liabilities in the computation of overhead will have been disbursed on the normal due date, and that any adjustment of such amounts through lesser payments or otherwise will be reflected in the year-end computation of overhead.

c. The internal procedures applicable to invoices, pay rolls, and the primary distribution of journal entries have dealt with the origin of the items which make up the total overhead. The total overhead thus established must now be apportioned to the contract in an equitable manner.

82. Procedures.

In his statement of accounting policies, the contractor will have submitted for the approval of the auditor the bases and methods by which he proposes to apportion his total overhead. The contractor's procedures for carrying out the apportionment of overhead should include—

a. Checks to assure that when expenditures of an overhead nature, because of special circumstances, are charged directly to the contract, similar items are not included in overhead claims.

b. Checks to assure that the basis for apportionment is developed in a uniform and accurate manner. For example, if direct labor dollars is the basis, the inclusion of inspectors as direct labor in the labor charged to the contract but as indirect labor in respect to other work would result in overcharging the contract in the distribution of overhead.

c. When departmental rates are used, provision for currently revising the bases of proration to reflect significant changes in floor space, departmental investment in machinery and equipment, power consumed, etc.

SECTION VIII

MISCELLANEOUS

CAFETERIAS, COMMISSARIES, CANTEENS, ETC.

83. Introduction.

The procedure outlined elsewhere herein, with respect to the review of the system of internal control is, in general, applicable to situations involving cafeterias, commissaries, canteens, etc., operated by contractors in connection with CPFF contracts. However, certain aspects of their operations are sufficiently different from the operation of the principal contract to require special treatment.

578203°—44——3

84. Invoices, pay rolls, etc.

a. The internal procedures outlined under invoices and pay rolls should be observed in the operation of cafeterias and similar units to the extent applicable.

b. Inasuch as the purchase of many items—food and other perishable items used currently—require immediate decisions each day, the preparation of purchase orders in advance is often not practicable. Such purchases should, however, be systematically reviewed and checked by independent persons.

c. Receiving reports may not be prepared for cafeteria purchases but invoices are usually submitted with the merchandise and should be approved for receipt by a responsible person.

d. Purchases or expenditures of all kinds handled on a cash basis should be made from imprest funds and currently reimbursed according to regular procedures.

85. Control of inventories.

a. Food and supplies should be drawn from stores only by responsible personnel.

b. Weekly physical inventories of food should be taken to permit weekly determination of food costs.

86. Cash receipts and control of revenue.

a. Independent checks of cash receipts should be provided to the greatest practicable extent through cash registers, tickets or sales slips, inventory controls, and the like.

b. All gross receipts should be deposited each day intact in a bank account which has been separately established for these operations.

c. Revenue should be suitably classified.

d. Statistical controls such as number of meals served, average sale, and operating ratios should be utilized to the maximum extent practicable to control current operations.

e. Where dormitories or similar facilities are operated, records should be prepared by independent persons covering occupancy and availability of rentable rooms, and these records should be checked to charges to guest accounts and collection of revenue to provide assurance that all revenue is being properly credited.

f. Provision should be made for the independent checking of commissions receivable from the operation of vending machines by reference to contracts with concessionaires and by appropriate checking of the receipts.

87. General.

Profit and loss statements on cafeterias, commissaries, dormitories, etc., should be prepared at least once every 4 weeks.

SCRAP

88. Introduction.

The recovery value of scrap is important. Proper internal procedures should be maintained by the contractor so that all scrap applicable to the contract is carefully controlled to realize the maximum recovery. The term "scrap" includes all residual materials, spoiled products, damaged supplies, etc., arising out of any phase of operations under the contract.

89. Accumulation and control of scrap.

Procedures should be maintained to provide control, so far as practicable, over quantities of scrap resulting from the various manufacturing operations. This should include an appropriate record of all scrap as it is produced or as it is received from subcontractors.

90. Disposal of scrap.

a. Shipments should be made only in accordance with shipping orders which become the basis for billing to buyers.

b. The procedures should provide assurance that all credits from sale or other disposition of scrap are applied in reduction of contract costs.

c. Where scrap applicable to CPFF contracts cannot be segregated from other scrap, the basis of allocating the credit should be carefully developed.

CHAPTER 3

APPLICATION OF SELECTIVE AUDIT PROCEDURES

SECTION I

INTRODUCTION

91. Preparing audit program.

The audit program will be developed by the auditor in accordance with the procedures set forth in this manual after his reviews of the contractor's system of internal control and statement of accounting policies have been completed. Each part of the program will be based upon the adequacy of the internal control existing in the particular department or function and will be of such scope as will protect the interests of the Government. The program prepared by the auditor, together with the contractor's statement of accounting policies, will be submitted in accordance with the practice of the service involved to higher authority for review and approval. The audit program will be supported by such information relative to the system of internal control as will enable the higher authority to pass on its adequacy.

92. Need for general flexibility of procedures.

a. It is important that the auditor avoid a fixed and continuing pattern of procedure. By varying the application of selective audit procedures to different departments, shifts, and other sections of the work, a complete coverage of all sections can be accomplished over the life of the contract.

b. It is also important that the auditor constantly consider the adequacy of his program in the light of his day-to-day findings. Where given checks disclose errors or irregularities, the scope of the audit must be extended to protect the interests of the Government.

93. Direction of audit effort.

a. The auditor will direct his audit work in a manner which protects the Government in the most effective manner. In the case of certain classes of cost where there is ordinarily no question of allowability from a technical accounting standpoint, the selective method of audit can be employed to a relatively greater extent.

b. In the case of certain other accounts where the allowability may be less clear, there must be a more extensive review, and the working papers are to include analyses of such accounts sufficiently extensive to disclose their content. Examples of these accounts are executive compensation, taxes, depreciation, repairs, insurance, subscriptions, memberships and dues, donations, and professional services.

c. Special attention must also be given to items which are large in amount, uncommon in nature, or which, because of other circumstances, appear particularly to concern the Government's interests. All unusual matters are to be followed through to a final conclusion, and any necessary action is to be taken.

94. Audit of particular portion or phase of transactions.

In the audit of a given portion of the transactions or phase of the operations, there are certain important requirements to be observed:

a. The portion or phase examined is to be representative of the total group from which it is selected. The selection must be made without regard to convenience or availability of data or to difficulties involved.

b. The portion or phase selected must be checked out completely and without exception.

c. To be effective, the selective auditing procedures must be carried out only after the contractor has recorded the distribution of the transactions in such a manner and subject to such control by the auditor that changes cannot be made without detection subsequent to the selective auditing and prior to reimbursement.

This can be accomplished, preferably, by the auditor retaining possession of the documents showing the accounting distribution or, where this is not practicable, by maintaining appropriate detailed lists until the given auditing procedures have been carried out.

d. If the portion audited indicates numerous errors, the scope of the examination must be extended to a detailed check of that phase of the accounts.

95. Representative number.

In this manual, the term "representative number" is frequently used in respect to selection of groups of transactions for auditing. The interpretation of the term is a matter of individual judgment and will depend upon the particular circumstances in each case. In general, however, the factors to be considered in given situations will include: dollar amount of items, points of origin, classes of items, departments involved, etc. In all cases, the objective is to obtain a sufficient cross section to justify reliance on the validity of the transactions of the group under examination.

96. Dual responsibility of auditor.

It may be stated again that the auditor has a dual responsibility. He must extend his procedures so far as is necessary to safeguard the interests of the Government; at the same time, he must avoid an extension of procedures which is unnecessary and which unduly duplicates the work of the contractor.

97. Working papers.

a. General Objectives. (1) Working papers serve two major purposes: they are an essential historical record of the auditing procedures carried out and of all significant data and findings incident to and arising out of the audit; and they are an important means of currently administering the auditing work. Working papers should therefore be prepared in such form as to achieve these objectives to the maximum extent.

(2) The papers should contain a clear and complete record of selective audit procedures carried out, by whom performed, and the results and findings. If the findings indicate the need for further action, the final disposition of such matters should be covered in the papers. However, extensive transcripts of the contractor's detailed records are usually unnecessary and are to be avoided wherever possible.

b. Form of Preparation. Each sheet must show the name of the contractor, the contract number, subject matter, the date, and the initials of the staff member who prepared it. No more than one type of subject matter should be covered on each sheet.

c. Indexing of Papers. So far as practicable, working papers and reimbursement vouchers should be cross-indexed.

d. Control Sheets over Current Work. In order that the auditor may properly control the day-to-day auditing and administer it efficiently, he should currently maintain appropriate control sheets setting forth the major auditing operations by departments and functions and dates.

e. Identification of Items Examined. In applying selective audit procedures, no notation of the audit steps performed or specific documents or transactions examined will be made on documents included in Government files to support public vouchers.

98. Audit of costs incurred prior to contract date.

The contract may provide for reimbursement of costs incurred in anticipation of the formal execution of the contract. Such costs should be scrutinized with special care.

99. Auditor's certificate on Form No. 1035.

a. When the auditor has completed the administrative audit of each public voucher in accordance with the procedures set forth in the Manual for Administrative Audit of Cost-Plus-A-Fixed-Fee Supply Contracts and has thus satisfied himself that the contractor's claim is reimbursable under the terms of the contract, he will complete the following certificate on the supporting Form No. 1035 or its equivalent:

"Approved" _____

_____

(Field auditor)

b. When the above certificate is completed, it should not be modified or qualified in any way. If an unqualified approval cannot be given, the auditor should be governed by the instructions

of his service or of the Army Air Forces, as the case may be.

SECTION II

INVOICES

100. Introduction.

a. The invoice audit procedure covers all vendors' invoices, transportation bills, travel expense reports, and other miscellaneous bills, whether chargeable directly to the contract, to overhead, or other accounts which may be partly applicable to the contract. The purpose of the audit procedures is to establish the credibility and allowability of all these invoices regardless of whether reimbursement is claimed immediately or at a later time through overhead.

b. The audit program will be based upon the review of internal procedures and will be adjusted to current findings.

101. Signatures.

The auditor will obtain a list of the specimen signatures and titles of persons authorized to approve or sign purchase orders, receiving reports, invoices, etc.

102. Auditing procedure—direct charges.

a. Manner of Submitting Documents by Contractor. (1) The contractor will submit his claim for reimbursement on Form No. 1034 supported by Form No. 1035, together with the invoices and related debit and credit memoranda listed thereon. The auditor will then prove the accuracy of the listing and summarization of the items included in the claim and will carry out his administrative audit.

(2) Where the auditor takes exception to particular items, which cannot be immediately adjusted, he will strike out such items on the Form No. 1035 and adjust the totals on both Forms Nos. 1034 and 1035 by drawing a single ink line through the incorrect amount and writing in the reduced amount immediately below. All changed totals should be initialed by the auditor. An extra sheet should also be prepared and attached to the Form No. 1035 detailing the downward changes made. A copy of this adjustment sheet, together with the rejected documents, will be returned to the contractor as formal notice of the rejections.

b. Examination of all Documents Submitted. All documents submitted will be reviewed for evidence, including initials and notations thereon, and by other appropriate means to determine—

(1) That invoices for materials, supplies, and other property are covered by—

(*a*) Purchase orders or agreements.

(*b*) Receiving reports approved by a Government representative.

(2) That extensions and footings have been checked.

(3) That travel expense reports, petty cash reimbursements, and invoices for services are approved by a responsible executive.

(4) That applicable deductions have been taken or that control has been established for subsequent deduction.

(5) That check numbers are shown on the invoices or on attached remittance advices.

(6) That all tax exemptions applicable to CPFF contracts have been obtained, including sales and use taxes, telephone and transportation taxes, etc.

(7) That the charge is allowable under the terms of the contract.

c. Detailed Check of Representative Number of Invoices Submitted. A representative number of invoices together with related debit and credit memoranda will be checked in detail to determine—

(1) That extensions and footings are correct.

(2) That quantities billed do not exceed the permissible variations as stated on the purchase order or allowed by the particular service.

(3) That prices and terms on the invoice agree with applicable purchase order and also with the bid in those cases where a bid was obtained.

(4) That, when required under the contract, purchase orders are approved by the contracting officer.

(5) That quantities billed are supported by receiving reports which agree either with the records retained in the receiving department or with a copy of the receiving report forwarded directly to the property accountable officer.

(6) In the case of travel expense reports—

(*a*) That unallowable expenditures because of type or amount are not included.

578203°—44——4

(*b*) That amounts claimed are in accordance with supporting documentary evidence.

(*c*) That reports are accurate as to computations.

(7) In the case of petty cash summaries—

(*a*) That supporting evidence is adequate.

(*b*) That items are correctly listed.

(*c*) That petty cash slips are properly canceled.

103. Invoices from subcontractors.

Subcontractors will submit to the prime contractors their commercial invoice for reimbursement. In addition, copies of Form No. 1035 should flow directly to the auditor of the prime contract from the auditor of the subcontract.

104. Invoices from "time and material" vendors.

With respect to "time and material" invoices the auditor will assure himself that such charges have been appropriately audited by the contractor from the records of the "time and material" vendor. The audit program followed by the contractor should be reviewed in a representative number of cases and, where deemed advisable, the auditor should determine, by actual visit to the vendor's plant, that the contractor is making adequate audits.

105. Interplant or interdivisional charges.

At the originating plant the invoices will be subjected to the same auditing procedures as are set forth in this manual for reimbursement vouchers.

106. Government inspection reports on material received.

Checks will be made to see that all Government inspection reports are being reviewed by the contractor for rejections. A representative number of such reports which indicate rejections will be examined and traced to ascertain that appropriate charges have been made against vendors.

107. Receiving and inspection procedure prescribed by industrial property accounting manual.

a. With respect to the receiving and inspection of materials and other property, it is unnecessary for the contracting officer to require Government employees designated by him to duplicate completely the quantity check and quality inspection performed by the contractor in connection with materials and other property received for use on a contract provided that—

(1) Written evidence of quantity receipt, quality inspection, and acceptance is obtained from the contractor. The contractor's receiving reports are considered adequate to satisfy this requirement if—

(*a*) A written statement is obtained from the contractor listing the names of persons authorized to receive and accept materials and other property for the contractor for use on his contract in accordance with the terms of it.

(*b*) Receiving reports indicating receipt and acceptance are signed by persons authorized in accordance with (*a*) above.

(2) When the contractor's quality inspection functions are not conducted simultaneously with the quantity check, the contractor's routines provide for advising the accountable property officer of the results of such inspection when completed.

(3) The contracting officer satisfies himself that the contractor's technical methods of quality inspection are competent, that the contractor's procedures with respect to quantity receipt and physical and accounting control of such materials and property conform to good commercial practice, and that all such methods and procedures are adequate to protect the interests of the Government.

(4) The contracting officer, by frequent observation, assures himself that such procedures and methods are being effectively carried out.

b. When the provisions as outlined in *a* above have been met, the contracting officer will require only such counts and inspection by Government employees as in his judgment are suitable in the circumstances. Where quantity checks and quality inspection of specific lots of material received are made by Government employees, the following requirements will be observed:

(1) *Quantity checks.* (*a*) The Government checker will obtain the accountable property officer's copy of the contractor's receiving report as prepared by the contractor's checker and independently check the count on a surprise basis. If such a copy of the receiving report is not available, the Government checker will prepare an independent tally-in sheet and will obtain the tally-in sheet of the contractor's checker for comparison.

(*b*) The Government checker will sign the contractor's record and the contractor's checker will sign the Government's record as evidence that the counts are in agreement when such is the case. All differences will be reconciled. If a Government tally-in sheet is prepared it will be attached to the related property voucher in the accountable property officer's file. If the check has been made against the copy of the contractor's receiving report for retention by the accountable property officer as a property voucher, a suitable notation indicating the results of the check will be made thereon by the Government checker.

(2) *Quality inspection.* (*a*) Where the quantity check includes quality inspection by a Government employee, the extent of such inspection will be noted on the Government tally-in sheet or receiving report copy.

(*b*) Where "delayed" inspection of material is made by a Government employee, the extent of such inspection will be noted on an inspection report or on an inspection copy of the contractor's receiving report which will be signed by the Government employee making the inspection and furnished to the Government representative charged with the administration of the Government selective count and inspection procedure for subsequent attachment to the related property voucher in the accountable property officer's files.

(3) *Approval of receiving reports.* (*a*) The Government representative, or his delegate, charged with the administration of the Government selective count and inspection procedure will review *all* receiving reports. Based on such review and relying on the procedures authorized in *a* above and so much of *b* as appears above, he will execute the following certificate on all receiving reports which are approved by him:

> "Approved in accordance with the requirements of the Industrial Property Accounting Manual."
>
> ----------

(*b*) The foregoing certificate, for Government purposes, is required only on the copy of the receiving report to which the Government auditor refers in carrying out the administrative audit of the contractor's claim for reimbursement.

c. The procedure as outlined in *a* and *b* above is considered adequate to permit—

(1) The accomplishment of Public Voucher Form No. 1034 by the contracting officer in connection with the receipt and inspection of materials and other property which involve the preparation of public vouchers.

(2) The acknowledgment of receipt by the accountable property officer as required in connection with public property (Government furnished materials and equipment) received for issue to the contractor for use on his contract.

108. Auditing procedure—invoices other than direct charges.

a. The same auditing procedures outlined for invoices representing direct charges will also be applied, with minor exceptions, to overhead and other invoices involving the contract.

b. Since reimbursement will not be claimed immediately, the auditor will have the alternative of examining the invoices from day to day as entered by the contractor or making the examination at the close of the month. Under the day-to-day basis, the auditor should maintain a daily accumulative record of the totals charged to overhead and trace the final monthly totals into the ledger accounts. If mechanical bookkeeping equipment is used, an additional copy of the distribution record may be obtainable for control purposes.

c. The day-to-day procedure will ordinarily be suitable when the bulk of the contractor's business is CPFF. If the CPFF business is not predominant, the examination of overhead invoices will normally be made after the close of the month.

d. The audit procedures for the general review of the invoices outlined in paragraph 102, with the exception of subsection *b* (1) (*b*), will apply to overhead invoices with the provision that such review is to be applied only to a representative number of the overhead invoices when the CPFF contracts are not the predominant part of the contractor's business.

e. The audit procedures for the detailed check of invoices outlined in paragraph 102*c* are to be applied only when the CPFF contracts are predominant.

f. The footings of the invoice distribution record (purchase journal, voucher record, or other form) are to be proved.

g. Where telephone toll and long distance charges are handled through overhead, the auditor will determine that Federal tax exemptions have been handled in the manner set forth in paragraph 54.

109. Bank accounts and proof of payment.

a. Whenever the contract requires it, and preferably in all other cases, the contractor should maintain a special bank account or accounts for CPFF contracts, and in such cases the auditor should obtain periodic statements directly from the bank and have all reconcilements made under his control.

b. If special bank accounts are not maintained, a similar reconcilement should be made at intervals, depending on the extent of CPFF business in relation to the total activity of the account.

c. Check numbers should in all cases be shown on the Form No. 1035 (or an equivalent form) submitted by the contractor for audit. Such check numbers will be traced by the auditor to paid bank checks to establish payment by the contractor.

110. Contractor's insurance program.

The auditor should determine that the contractor's insurance program is in accordance with applicable regulations, and that costs claimed for reimbursement do not include either premiums on Government-owned property or on contractor-owned property not necessary to the performance of the contract or premiums on other property in excess of the War Department Rating Plan.

SECTION III

PAY ROLLS

111. Introduction.

a. The pay roll audit procedure covers all pay roll disbursements charged directly to the contract or to overhead and other accounts which may ultimately affect the cost of the contract. The purpose of the pay roll audit procedure is: to establish the credibility of the record of all pay roll expenditures at the time of original entry; and to determine that claims for reimbursement are in accordance with the terms of the contract. The audit program will be based upon the results of the review of the internal procedures and will be adjusted to current findings.

b. The audit procedures include two main phases—

(1) Those procedures concerned with the day-to-day preparation of the basic pay roll records.

(2) Those procedures dealing with pay roll records and distribution summaries prepared at the close of each pay roll period. The two groups of procedures are closely related and combine to accomplish the total audit objective.

c. Pay roll audit procedures are set forth separately for hourly rate and salary pay rolls in accordance with the plan followed under internal procedures.

HOURLY RATE PAY ROLLS

112. Procedures—daily pay roll records.

a. From time to time the auditor will witness the ringing in and out of time cards of employees in each department and for each shift.

b. In departments working both on CPFF contracts and other work, and particularly when the men frequently shift between these classes of work, a check of the distribution of the time becomes especially important. Floor checks will be made from time to time in each department and on each shift to determine that the men ringing in are actually on the job and are charging their time to the correct job or contract. In addition to the floor checks, in such cases, a representative portion of the labor tickets should be traced to production control records or such other independently maintained records as are available.

c. In making floor checks the following requirements will be observed:

(1) The floor check is to be on a surprise basis.

(2) A list of all men on the pay roll in the department or group to be checked will be prepared and all names on it will then be accounted for.

(3) The names of all employees not on the job will be checked to the clock record and satisfactory explanations will be obtained for all absences.

(4) Time tickets of individual persons will be checked on work being done and applicability of occupational rates.

(5) The daily distribution will be checked to the record of the floor check as soon as the former record is available, and such distribution will be traced into the summary for the pay period.

(6) The names of employees on the pay roll will be checked to the record of the floor check prepared at the end of the pay period to check out the employees listed in it for the departments and days covered by the floor checks.

d. The agreement of the distribution record for the day on which the floor check was made will be checked with the hours shown by the attendance record.

e. The auditor will witness from time to time, on a surprise basis, the pay-off in each department and for each shift, observing the following requirements:

(1) The amounts on the envelopes or checks will be checked against the pay roll before the pay-off. Employee numbers on checks or envelopes will be checked against badge numbers as pay-off is made.

(2) The control over the pay-off will be maintained jointly with contractor's paymasters.

(3) Unclaimed wages will be placed in the hands of an independent responsible person. A list of these unclaimed wages will be prepared by the auditor and subsequent disposition of the items witnessed.

113. Auditing pay roll.

a. The auditor will obtain a list of the signatures and titles of persons authorized to establish rates, approve pay rolls, sign checks, etc.

b. A representative portion of the names on the pay roll will be checked to personnel records to determine authority for employment and rates used.

c. A representative portion of the hours will be checked to basic attendance records (usually clock cards).

d. Extensions will be reviewed and checks made of a representative number of individual computations.

e. All page totals will be traced to summaries. As a general rule, all footings of individual pages and summaries will be proved. However, in cases involving very large pay rolls, and where there are reliable internal checks, substantial tests of footings may be adequate.

114. Auditing distribution record.

a. The summary distributions involving the contract will be checked to intermediate summaries or totals of individual lots of time-distribution tickets.

b. A representative portion of the intermediate summaries or lot totals of tickets will be checked for accuracy of footings.

c. A representative portion of supporting tickets will be reviewed as to extensions, description of work, and accuracy of accounting distribution.

d. The auditor will determine that the summary distribution is approved by a responsible executive and agrees with the total shown on the pay roll.

SALARY PAY ROLLS

115. Audit of pay roll and distribution record.

a. The auditor will obtain a list of the signatures and titles of persons authorized to establish rates, approve pay rolls, sign checks, etc.

b. A representative portion of the names on the pay roll will be checked to personnel records for authority of employment and salary rates.

c. In small companies the attendance of personnel may have been properly established through the review of internal control. Where this is not true it will be necessary to make a modified form of floor check.

d. The auditor will determine that the pay roll, including both regular and overtime payments, has been approved by one or more qualified executives and that overtime is being paid in accordance with established policies.

e. The auditor will review the distribution of the pay roll to determine that it is based upon proper facts and is approved by responsible executives.

f. As a general rule, the accuracy of all footings will be proved and a representative number of extensions checked. However, in cases involving very large payrolls, and where there are reliable internal checks, substantial tests of footings may be adequate.

g. All footings will be traced to summaries and the summaries proved.

h. In connection with the audit of salary pay roll charges to overhead, the auditor will submit to the contracting officer for his review and approval a complete list of executive compensation and, with respect to other salaries, any specific instances of apparently excessive salary rates or rate increases. The audit working papers will include a record of instances brought to the contracting officer's attention and, in the case of disapproval, the action taken.

ALL PAY ROLLS

116. General.

a. (1) In plants where separate pay roll bank accounts are maintained covering CPFF operations, the monthly reconciliations will be made by or under the control of the auditor. A representative portion of names and endorsements will be examined.

(2) In plants where separate pay roll bank accounts are not maintained covering CPFF operations, a similar reconcilement should be made at intervals depending on the extent of CPFF business in relation to the total activity of the accounts.

b. Specific claims for reimbursement of salaries on a direct charge basis in plants having other than CPFF business will be traced to the pay roll distribution.

c. Where the contractor has been reimbursed on a gross pay roll basis, the auditor should determine, by reference to appropriate disbursement records and paid bank checks, that the amounts withheld are subsequently paid to the proper parties by the contractor.

d. Where the contractor has been reimbursed on a gross pay roll basis for deductions covering the purchase of war bonds, the auditor should—

(1) Determine that amounts deducted from pay rolls have been properly deposited and recorded.

(2) Ascertain that checks issued against the bank account are supported by lists of employees receiving the bonds, stamps, or refunds.

(3) Review the reconcilement of contractor's war bond bank account with the control account.

(4) Make appropriate tests of the trial balance of individual subscribers' accounts to determine that the amounts shown are in agreement with the individual accounts.

(5) In a representative number of cases, determine that amounts deducted on pay rolls and amounts shown on lists of bonds, stamps, and refunds received by employees are properly posted to individual subscribers' accounts.

e. The auditor will determine that all contract and War Department administrative limitations on compensation have been observed.

SECTION IV

JOURNAL ENTRIES

117. Introduction.

a. The invoice and pay roll audit procedures have dealt with the authenticity of all cash disbursements. Where these disbursements are charged to asset accounts such as contractor's stores, property and the like, journal entries are made by which the amounts originally charged are allocated directly to the contract or to accounts such as overhead which may subsequently affect the contract. While these charges to overhead do not immediately constitute the basis of a claim for reimbursement, it is necessary that the auditor establish their authenticity. The auditor is then in a position to deal properly with the application of overhead and the associated claims for reimbursement.

b. The audit procedures carried out will be based upon the review of internal control modified in the light of current findings.

c. Before beginning the audit of the various sections which follow, the auditor will obtain a list of signatures and titles of all persons authorized to sign or approve the individual entries and supporting papers.

118. Materials and supplies from contractor-owned stores.

a. A representative portion of invoices covering items charged to stores will be checked to the stores' records to determine accuracy of the postings of quantities and prices.

b. A representative number of requisitions will be examined to determine—

(1) That pricing is consistently applied on the basis of an acceptable method such as first in—first out, last in—first out, or average cost.

(2) That the using department is indicated by receipt or other designation.

(3) That computations are accurate.

(4) That requisitions are authorized by responsible personnel.

(5) That the accounting distribution is proper.

(6) That quantities have been approved by a Government property officer.

c. Summaries of requisitions will be examined to determine—

(1) By addition of the requisition totals that the summary footings are correct and the requisitions correctly listed.

(2) That the total distribution is approved by a responsible executive.

d. The requisitions will be reviewed to disclose the inclusion of items similar to those charged directly from purchase invoices. Any such items will be investigated to disclose possible duplication.

119. Work order charges.

a. The auditor will determine that all work orders have been authorized by responsible executives.

b. A representative portion of the detailed charges appearing on work orders are to be traced to originating sources.

c. Accuracy of totals of postings on the work order form, or its equivalent, will be proved.

d. The auditor will determine that clearance is being made at least monthly.

e. The auditor will review for correctness all accounting distributions involved in clearing the work orders and determine that they are approved by a responsible executive.

f. Where work orders are summarized, the accuracy of summarization will be checked and the auditor will determine that the summary distribution is approved by a responsible executive.

120. Write-off of deferred charges.

a. The auditor will examine a representative number of items charged to deferred accounts and determine that the basis of deferment and method of write-off are sound and in accordance with established policies.

b. Reasonable checks will be made to determine the accuracy with which the method of write-off is being applied.

c. The auditor will determine that distributions involving the contract, both directly and indirectly, have been approved by a responsible executive.

121. Depreciation.

a. The auditor will examine a representative number of charges to property accounts for the contract period to determine that capitalizations are made at cost and in accordance with established policies, that they represent proper types of charges, and are approved by a responsible executive.

b. The auditor will determine that retirements and sales are being properly handled—

(1) That sales, items scrapped, etc., are being promptly reported.

(2) That retirements are being properly cleared from property and reserve for depreciation accounts.

c. Depreciation charges will be reveiwed and a representative number of individual calculations examined to determine—

(1) That rates used are in accordance with established policies and are reasonable.

(2) That rates are being applied against correct asset balances.

(3) That computations are accurate.

d. The auditor will determine that depreciation charges directly to the contract, or to overhead accounts which may affect the contract, are based on proper facts, and approved by responsible executives.

122. Accrued expenses.

a. The auditor will determine that the basis for accrual in each case is sound and in accordance with established policies.

b. Checks will be made of a representative portion of the calculations to determine their accuracy.

c. Supplementary checks will be utilized to the extent available. For example, accruals for unemployment taxes can be checked to pay rolls and to reports rendered to taxing authorities.

d. The auditor will determine that distributions affecting the contract, both directly and indirectly, have been approved by a responsible executive.

APPLICATION OF OVERHEAD

123. Introduction.

a. The audit procedures carried out under invoices, pay rolls, and the preceding journal entries have dealt with the authenticity of the various items which make up the total overhead. It is next necessary to determine that the overhead apportioned to the contract is in accordance with the contractor's statement of accounting policies and that the results are in accordance with the terms of the contract.

b. The contractor normally makes his claim for reimbursement for overhead on a monthly basis, using a tentative rate. The claims made on this tentative basis are then subject to final adjustment at the end of each year. While the propriety of a particular overhead item may not directly affect the claims currently made, it will affect the year-end settlement. It is essential that the overhead be audited currently both to avoid an accumulation of audit work and also to be sure that a proper margin of safety exists over amounts currently claimed.

124. Audit of monthly overhead statements.

a. Overhead statements will be prepared by the contractor and will be examined by the auditor as to the allowability of the various accounts. These statements will ordinarily be acceptable as to form when prepared according to the contractor's chart of accounts, provided they are in reasonable detail and the account titles are sufficiently descriptive to disclose their content and allowability under the terms of the contract.

b. Investigation will be made of important monthly fluctuations in the individual overhead accounts.

c. Items ordinarily a part of overhead, but charged directly to the contract, will be investigated to make sure that similar items are excluded from overhead.

d. Appropriate checks will be made to determine the accuracy and uniformity with which amounts or quantities used as the basis for proration (as, for example, direct labor dollars) are developed. Where possible, such amounts will be tied in to results obtained through other audit procedures.

e. The accuracy of the overhead proration computations will be established.

f. The auditor will determine that all distributions of overhead affecting the contract have been approved by responsible executives.

g. All current claims for reimbursement of overhead will be reviewed to determine that amounts claimed are sufficiently under the amount of actual overhead to provide a proper margin of safety.

h. Since some elements of overhead are on an accrual basis with the understanding that such items will be disbursed on the normal due date, it is the auditor's responsibility to determine that important adjustments incident to the payments are properly reflected in the final overhead settlement.

i. Where telephone toll and long distance charges are handled through overhead, the auditor will determine that the tax exemption as determined under the procedures set forth in paragraph 54 is properly deducted from the contractor's overhead claim.

125. Audit of year-end overhead statements.

The year-end statements prepared by the contractor are the bases for settlements which cover an entire year. These statements incorporate the results of all interim statements and claims made, and show the net balances which normally represent amounts due from the Government.

a. The audit work carried out during the year in connection with monthly claims provides the major basis for establishing the validity and accuracy of the year-end statement. The individual procedures should, however, be extended as necessary to satisfy the auditor as to the results for the entire year.

b. The auditor will also determine that claims previously made are propertly listed in the year-end statement and that all year-end adjustments of accruals are recognized.

c. The auditor should determine that physical inventories of supplies and indirect materials on hand in storerooms or on the floor are taken at the end of the fiscal year and the relative overhead accounts appropriately adjusted. If such inventories have not been taken, the auditor must consider the necessity of a suitable adjustment in the year-end overhead settlement.

d. The auditor should determine that important charges to overhead represented by liabilities at the year-end have been liquidated by actual payments since the year-end date. In accomplishing this objective, he should make sure that—

(1) The contractor's books have been closed.

(2) Sufficient time has elapsed to establish the accuracy of liabilities shown at the year-end.

SECTION V

MISCELLANEOUS

CAFETERIAS, COMMISSARIES, CANTEENS, ETC.

126. Introduction.

a. The purpose of the auditing procedures relating to cafeterias, commissaries, and canteens is to establish the credibility of the accounts, to ascertain that proper controls are in operation with regard to inventories and cash, and to determine that the net income from operations has been applied against the costs of the contract. These procedures may also be applied to the audit of cafeterias operated by concessionaires.

b. The procedures specified in this manual with respect to cash disbursements for pay rolls, invoices, etc., will, in general, be applicable. Those instructions will be followed to the extent practicable in conjunction with the special procedures set forth in this chapter.

c. The audit program will be based upon the findings made in the review of the internal procedures, and will be adjusted to current findings.

127. Invoices, pay rolls, etc.

a. A representative number of invoices will be examined to determine that they are approved for prices and receipt of merchandise by responsible persons.

b. A representative number of pay rolls will be examined to check the number of employees, rates of pay, and approval by responsible persons.

c. A representative number of cash disbursement entries will be supported by paid invoices, petty cash vouchers, pay rolls, etc.

128. Control of inventories.

a. Where perpetual inventories are maintained, the auditor will determine that the inventories are being properly relieved of the cost of items withdrawn and losses through spoilage.

b. The auditor will check the physical inventories at appropriate intervals. This may be accomplished through supervision of the taking of inventories by contractors' employees.

129. Cash receipts and control of revenue.

a. The auditor will determine that receipts are being properly recorded at time of sale.

(1) A representative number of sales checks or tickets should be compared with cash register tapes.

(2) If a food checker is maintained, a representative number of day's cash receipts, as recorded, will be reconciled to the food checker's control totals.

b. Cash receipts as recorded at time of sale will be traced to book records.

(1) Compare totals of cash register tapes or other records with daily cash receipts recorded for a representative period.

(2) Check daily receipts to bank deposits for a representative period.

(3) Reconcile bank account if a separate bank account is maintained.

c. Compare statistics such as percentages of food costs to sales, expense ratios, etc., with ratios for previous periods.

d. In the event that costs of food and service appear to be excessive, explanations thereof should be obtained.

e. Where dormitories are operated, the rental charges and the collection of revenue should be compared with records of occupancy of rentable rooms for representative periods to determine that all revenue is properly credited.

f. Appropriate checks will be made to ascertain that commissions from concessionaires are being received in accordance with the terms of the concessionaire's contract and are being applied according to approved accounting policies.

130. General.

a. The auditor will trace the postings from cash receipts and cash disbursements records to the general ledger for representative periods.

b. The individual items shown on the contractor's summary reports will be traced to the general ledger.

c. The accuracy of the summary statements will be checked and the application of the net balance to the cost of the contract will be verified.

SCRAP

131. Introduction.

The objective of the audit procedures with respect to scrap is to determine that scrap resulting from materials and supplies charged to the contract is adequately controlled so that the proper credit is obtained by the Government. The program will be based upon the results of the review of internal control and will be adjusted in accordance with current findings.

132. Accumulation and care of scrap.

a. The auditor will carefully survey the source from which scrap originates and where practicable will ascertain from engineering estimates and operating records the quantities normally derived from the various operations. The actual results should be compared and any significant variations investigated.

b. The physical and accounting controls over stores of scrap will be studied to determine whether the interests of the Government are being adequately protected.

133. Disposition of scrap.

a. Quantities disposed of should be compared with quantities obtained from operations and with stocks still on hand to determine that all scrap is being accounted for.

b. All sales or other disposition should be checked to determine that credits therefrom are properly applied as a reduction of the cost of the contract.

c. In cases where it is not practicable physically to segregate scrap applicable to the contract, the bases of allocation should be reviewed to determine whether they are equitable and accurately applied.

Chapter 4 (pars. 201 to 229) to be inserted following this page.

APPENDIX

WAR DEPARTMENT,
HEADQUARTERS, SERVICES OF SUPPLY,
WASHINGTON, May 27, 1942.

SPBFA—6A.
Memorandum for:

The Chief, Chemical Warfare Service,
The Chief of Engineers,
The Chief of Ordnance,
The Quartermaster General,
The Chief Signal Officer,
The Surgeon General,
The Chief of the Transportation Service,
The Commanding Generals of all Corps Areas,
The Chief of the General Depot Service,
The Commanding General, Matériel Command, Army Air Forces,

Copies to:

The Chief of Administrative Services,
The Judge Advocate General,
The Chief of Finance,
The National Guard Bureau,
The Inspector General.

Subject: Administrative Audit of Cost-Plus-A-Fixed-Fee Contracts.

Introduction

1. The auditing procedures being followed by the various services for auditing cost-plus-a-fixed-fee contracts are now burdensome and with the imminent increase in expenditures are likely to prove unworkable. If this situation can be remedied, much needed manpower will be made available for other duties, costs will be reduced and reimbursement of contractors will be accelerated. It is believed that the remedy lies in the adoption of modified procedures which nevertheless will adequately protect the interests of the Government.

2. The basic philosophy of the auditing manuals of the Services has been a detailed check of every item in support of the contractors' costs. The rigid procedures now prescribed may result in spending as much time and effort on a small item of cost as is spent on a large and important item; the records of a contractor with a complete and efficient accounting system, of proven general accuracy, are subjected to the same amount of detailed checking as the records of contractors having unsatisfactory and poorly maintained accounting systems. While these rigid and detailed procedures can be carried out in normal times, the present large volume of contracts to be audited and the limited supply of competent manpower make some modification imperative.

Elimination of Duplication

3. The objective of an audit of a cost-plus-a-fixed-fee contract is to ascertain that the contractor's invoices, certified as correct by him, are in accordance with the provisions of the contract and are substantiated by his accounting records and other supporting evidence. To achieve this objective it is not imperative to make a complete and detailed examination of all transactions. An adequate and more practical method, suitable in most cases, is the selection of representative sections of the transactions or phases of the procedures for auditing after considering the individual circumstances in each situation.

4. Where the contractor maintains a satisfactory system of internal control, under which, for his own protection, all expenditures on account of the contract are audited by his own organization, it is apparent that the interests of the Government can be protected, without duplicating the work performed by the contractor, by instituting a selective and flexible method of audit by a relatively small number of experienced auditors.

5. A satisfactory system of internal control requires a separation of activities and respon-

sibilities within the contractor's staff and an application of accounting controls so that all important phases of the transactions are subject to cross-checks. Such a system minimizes the possibility of errors and fraud and justifies considered departure from rigid detailed audit procedures.

6. The extent of the application of the selective audit procedure, where an effective internal control is present, will be determined, in accordance with certain principles enunciated hereinafter, by the Chief Auditor of the project subject to review by the Chief Auditor of the Service involved. The auditing manuals of the Services will be revised to incorporate therein regulations governing the application of these principles.

7. The adoption of a selective method of auditing does not reduce in any way the necessity of a review of documents and schedules in support of all vouchers. By the elimination of unproductive detailed checking more time is available for such a review by the experienced auditor predicated on a carefully predetermined audit program and the knowledge of its consummation by his staff.

Principles Governing Extent of Selective Audit Procedure

8. The Chief Auditor of the project will first review the system of internal control and prepare a thorough report thereon which will include answers to a specific list of questions designed to disclose the adequacy of the internal control. If the internal control should not be adequate and if it is practicable to correct the deficiencies the contractor should be required to do so.

9. Upon approval of the system of internal control, the problem then becomes one of determining the extent to which the selective procedures will be applied. In the case of certain classes of costs as to which there is ordinarily no question of allowability from a technical standpoint, the problem is to substantiate their authenticity and mathematical accuracy. Where there is a considerable volume of individual transactions of these classes, a selective method of auditing may be appropriately applied.

10. Certain other accounts, which are more likely to include costs of doubtful allowability, will be subjected to more extensive review and in many cases to a complete detailed examination. Examples of such accounts are executive salaries and bonuses, traveling expense, taxes, depreciation and amortization, insurance, subscriptions, memberships and dues, donations, and professional services.

11. In carrying out a program of selective auditing, it is important to avoid a fixed and continuing pattern of procedure and to revise the scope and extent of the program currently. Care should also be taken to select a representative group of each of the various classes of transactions such as material purchases, supply purchases, store requisitions, pay rolls, etc., but emphasis should be placed on examination of the larger items. An audit of a relatively small number of material purchase transactions, for example, may cover the greater part of the dollar total of such transactions.

12. When the review of the internal control procedures discloses that as to certain phases of the accounts the internal control is not entirely adequate a wider range of transactions should be checked and where the selective audit discloses numerous errors, a complete check must be made of that phase of the accounts.

13. These rules are stated as a guide and the auditor should always consider the necessity of expanding his program in the light of the surrounding conditions. He must be sure that the contractor's system of accounting adequately protects the interests of the Government, and he must carry his checking far enough to satisfy himself as to the credibility of the accounting records and the supporting data.

14. The project auditor will include in his files a complete record of:

a. The extent and nature of his periodic review of the established system of internal control and his conclusions upon which the program of selective auditing is based.

b. The extent of the selective auditing done, by whom performed, and the results of such auditing.

15. Selective auditing in those cases where there are satisfactory internal controls will not only reduce the cost of auditing but will result in more satisfactory audits. Reimbursement of

cost-plus-a-fixed-fee contractors will be accelerated.

Certification of Vouchers by Contracting Officers

16. Contracting officers are authorized to certify vouchers for payment when, through the field auditors, they have carried out the procedures outlined herein, provided that:

a. The contractor has certified that the bill is correct and just; that payment therefor has not been received; that all statutory requirements as to American production and labor standards, and all conditions of purchase applicable to the transactions have been complied with; and (if applicable) that state and local taxes are not included in the amounts billed.

b. The expenditures as described in the supporting documents are determined to be properly reimbursable under the contract.

c. All required documentary evidence is attached to the voucher.

Responsibility of Disbursing Officers

17. AR 35–180 states in paragraph 3:

Responsibility in connection with certificates of fact,

a. Disbursing officers are not responsible for the correctness of statements of fact appearing on pay rolls of which they can have no knowledge but which are certified to by the proper administrative officers; they are, however, responsible for the correct application of laws and regulations to the statement of facts certified and for the sufficiency of the facts stated. (25 Comp. Dec. 437.)

b. The financial responsibility for an improper certification will be determined by a board of officers convened by the commanding officer at the request of the disbursing officer who made erroneous disbursements thereon. Board proceedings, with appropriate recommendations, will be forwarded to The Adjutant General for final action of the Secretary of War. (See AR 35–1040.)

18. Disbursing officers are hereby authorized to accept the certification of facts by contracting officers executed pursuant to the modified auditing procedures outlined in this directive. In the event of any disallowance in any disbursing officer's account resulting from the improper certification of facts by a contracting officer predicated on the administrative auditing procedures outlined herein, and in the absence of fraud or negligence on the part of the disbursing officer involved, the War Department will take appropriate steps to effect clearance of or relief from such disallowance.

Revision of Auditing Manuals of the Services

19. A committee will be formed, representing the interested services, to coordinate a revision of the manuals providing for the application of the principles governing the use of selective auditing procedures outlined in this directive. Each of the services interested in cost-plus-a-fixed-fee auditing will appoint a representative at the earliest possible moment to serve on this committee.

BY COMMAND OF
LIEUTENANT GENERAL SOMERVELL:

(S.) A. H. CARTER,
A. H. Carter,
Brigadier General,
Director, Fiscal Division.

APPROVED:

(S.) BREHON SOMERVELL
Brehon Somervell,
Lieutenant General, Commanding.

APPROVED:

(S.) ROBERT P. PATTERSON,
Robert P. Patterson,
Under Secretary of War.

WAR DEPARTMENT TECHNICAL MANUAL

TM 14-1000

ADMINISTRATIVE AUDIT PROCEDURES FOR COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

WAR DEPARTMENT • 18 DECEMBER 1943

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WAR DEPARTMENT,
WASHINGTON 25, D. C., 18 December 1943.

Chapter 4, TM 14–1000, Administrative Audit Procedures for Cost-Plus-a-Fixed-Fee Supply Contracts, is published for the information and guidance of all concerned.

[A. G. 300.7 (24 Dec 43).]

BY ORDER OF THE SECRETARY OF WAR:

G. C. MARSHALL,
Chief of Staff.

OFFICIAL:
J. A. ULIO,
Major General,
The Adjutant General.

DISTRIBUTION:
D (2); B (2); C 14 (5).
(For explanation of symbols see FM 21–6.)

45-27743

FOREWORD

This chapter, "Final Settlement of Cost-Plus-a-Fixed-Fee Supply Contracts," is chapter 4 of TM 14–1000, Administrative Audit Procedures for Cost-Plus-a-Fixed-Fee Supply Contracts. The audit procedures which will comprise chapters 1, 2, and 3 have previously been issued as the Manual for Administrative Audit of Cost-Plus-a-Fixed-Fee Supply Contracts under date of 14 August 1942. These three chapters are now in the process of being revised and subsequently will be issued as chapters 1, 2, and 3 of TM 14–1000.

Changes to this manual will be supplied on a page basis, and will be published as required. As change pages are received they will be inserted in their proper place, and the replaced pages destroyed.

Each page of the manual bears a date in its upper inside corner. This date is the date of the publication. Pages which represent changes will carry the date and number of the change.

Pages are numbered consecutively throughout the book. If new pages are added within the book the added pages will carry alphabetical suffixes—"A," "B," "C," and so on. For example, if a new page is added between 101 and 102, the page will be numbered 101–A. A second additional page in the same place would be numbered 101–B, and so on.

CONTENTS

CHAPTER 4. FINAL SETTLEMENT OF COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS.

		Paragraphs
Section I.	General	201–207
II.	Procedures for final settlement which have general applicability	208–223
III.	Additional procedures for final settlement applicable in 100 percent CPFF plants where all CPFF contracts are terminated	224–228
IV.	Additional procedures for final settlement applicable in all cases in mixed plants	229

CHAPTER 4

FINAL SETTLEMENT OF COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

SECTION I

GENERAL

201. Terminations defined.

Terminations of cost-plus-a-fixed-fee supply contracts, as used herein, include contracts under which all of the articles or services covered by the contract have been completed and also contracts which have been canceled before completion either because of default on the part of the contractor or for the convenience of the Government.

202. General plan of final settlement.

a. During the period which follows the cessation of the regular operations under the contract the contractor should continue to present his claims in the regular manner for costs incurred prior to termination but not reimbursed and also for costs properly incurred subsequent to termination. These claims will be audited, and when approved, the appropriate offsets should normally be made against any existing advance payment funds.

b. Amounts collected by the contractor for the Government, including those amounts received from sources referred to in section 2 of this chapter, should either be transmitted directly to the disbursing officer or deducted from claims currently presented.

c. When in the opinion of the contracting officer substantially all of the charges pertaining directly and solely to the contract have been processed, this officer should fix a final settlement date. The term "final settlement date" refers to the date when all determinable costs have been approved for reimbursement and the contracting officer authorizes payment to the contractor of the net amount still due. It is recognized that additional claims under the terminated contract may arise subsequent thereto. As of the final settlement date, the contractor should prepare a summary of his charges and credits not processed, including the fee not yet received, and calculate the amount of the final settlement.

d. It is the contractor's responsibility to prepare his final claim accurately in accordance with the terms of the contract after considering all previous payments and collections. It is then the auditor's responsibility to satisfy himself in an appropriate manner that the final claim is accurate.

e. Numerous schedules are also required of the contractor. Some of these provide detail which directly supports items settled at or prior to the final settlement date, whereas others are for information only and will be used for later reference by governmental personnel after the date of final settlement. Such schedules should be prepared in sufficient number of copies to include at least two copies for governmental purposes.

f. After final settlement has been made, all papers and schedules pertaining to the settlement should be transmitted to the Chief of the

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Technical Service concerned, or to the Commanding General, Matériel Command, Army Air Forces. Thereafter, all claims of vendors, etc., should be presented to the officer concerned, as above described, and any further payments will be made directly by the Government.

203. Settlements of subcontractor claims.

a. Where the subcontracts (including purchase orders) are on a fixed-price basis, the settlements should be made in accordance with Procurement Regulations 15. In such cases the accounting personnel involved in the review and examination of subcontractors' claims will be governed by TM 14–1006, Administrative Accounting Procedures, Fixed-Price Supply Contract Terminations, now published as TM 14–320, War Department Termination Accounting Manual for Fixed-Price Supply Contracts.

b. The record of the settlement should include in each case—

(1) The written approval of the contracting officer.

(2) A release from the subcontractor as evidence that payment has been received and that it constitutes complete and final settlement of the claim.

c. With respect to CPFF subcontractors the procedures covering final settlements set forth in this chapter are equally applicable.

204. Documentary evidence requirements—fixed-price supply subcontracts.

a. Public vouchers covering reimbursement for payments made to fixed-price supply subcontractors in connection with termination settlements should include the final settlement agreement signed by the contractor and subcontractor and approved by the contracting officer, together with evidence that the provisions of that agreement have been complied with.

b. War Department requirements as to documentary evidence, such as are in force with respect to CPFF subcontracts, are not applicable to negotiated settlements covering terminated fixed-price supply subcontracts under a CPFF prime contract, and in the case of such negotiated settlements no such documentary evidence is to be submitted to the disbursing officer.

205. Extent to which Government will assume liabilities.

a. The termination provisions of the contract will govern the extent to which the Government will assume the liabilities incurred in connection with the contract but not determined at the date of final settlement. (See PR 15–651.2.)

b. The Government will not normally assume such liabilities incurred in connection with the contract unless there is a specific provision to that effect in the contract and then only with respect to charges pertaining directly and solely to the contract.

206. Manner of outlining final settlement procedures.

a. The auditing procedures to be followed during the period of final settlement should conform to those set forth in this entire manual.

b. The additional procedures required during the final settlement period involve the contractor, the contracting officer, and the auditor. Due to the impracticability of separating the activities of each of these parties, the procedures have been combined and treated together in this manual.

207. Procedures for final settlement.

Most procedures are generally applicable to all situations under which CPFF contracts are terminated whether these terminations are in 100 percent CPFF or mixed plants, and whether only a part or all of the CPFF contracts are being terminated. Certain additional procedures are applicable only in one or more of the above situations. The procedures are therefore grouped in such a manner as to indicate the types of situations to which they are applicable. These sections are as follows:

a. Procedures which have general applicability.

b. Additional procedures applicable in 100 percent CPFF plants where all CPFF contracts are terminated.

c. Additional procedures applicable in all cases in mixed plants.

SECTION II

PROCEDURE FOR FINAL SETTLEMENT WHICH HAVE GENERAL APPLICABILITY

208. Advance payment fund.

a. The balance remaining in the advance fund should be supported by schedules prepared by the contractor (to the extent such schedules have not previously been submitted for prior periods) showing all advances made or other increases and all reductions resulting from offsets of approved claims or repayments.

b. The procedures relating to the bank accounts which are a part of the advance payment fund, are set forth separately in paragraphs 209 and 210.

209. Where separate bank accounts are maintained for each contract.

a. When the activity of the bank accounts diminishes sufficiently, the contracting officer should establish a date after which no further checks will be issued. After a reasonable period of time the contractor should, at the direction of the contracting officer, send formal notices to *all* payees of checks issued which have not cleared the bank. Such notices should state that payment will be stopped on *all* checks not presented for payment by a designated date.

b. On the designated stop payment date, the contractor should formally notify the bank to stop payment on all checks not yet cleared and to inform holders of checks of the proper Government officer (see par. 202*f*), to whom checks should thereafter be presented and should authorize the auditor to obtain the final bank statements and paid checks directly from the bank. The auditor should then act in accordance with that authority.

c. The contractor should supply the auditor with lists of all checks for which payment has been stopped, prepared as follows:

(1) A list covering checks which represent disbursements for which the contractor *has* been reimbursed. This list should show date, check number, payee, amount of check, bureau voucher number, D.O. voucher number, and date on which contractor was reimbursed. In the case of pay roll checks such list should also show badge or employee number and social security number.

(2) A list covering checks which represent disbursements for which the contractor *has not* been reimbursed as of the stop payment date. This list should show date, check number, payee, amount of check, and, in those cases where items have been reimbursed at one time and subsequently deleted from a reimbursement voucher, the D.O. voucher number and date on which such deletion was made. This second list will be used by the Government for reference purposes only.

d. The accuracy of the amounts represented by the list of reimbursed items (*c*(1) above) should be established and the balance accounted for by the auditor in the final settlement.

e. A final reconciliation for each bank account should then be prepared by the contractor under the control of the auditor, and the agreement of the book balance with the amount used in the advance payment schedule determined.

f. The auditor should complete Certificates of Evidence of Payment for all checks which have cleared the bank up to the stop payment date.

210. Where Government funds are intermingled with contractor's funds.

The procedures set forth in paragraph 209 are generally applicable but with the following modifications:

a. The bank accounts should not be closed.

b. Formal notices to payees should be issued only with respect to direct charges to the contract.

c. Certificates of Evidence of Payment apply only to direct charges to the contract.

d. The auditor is not to be required to control or to check the contractor's bank reconciliation unless the preponderance of the contractor's business is performed under CPFF contracts or a special situation indicates the desirability of such a reconciliation.

211. Deposits made by contractor from Government funds.

a. Where deposits have been made by the contractor for telephone, electrical, insurance, or other types of services, and the contractor has been reimbursed by the Government, any of these deposits still outstanding should be re-

claimed by the contractor and credited to the Government.

b. The auditor should make such review of deposits originally made and now reclaimed as will assure him that the interests of the Government have been protected.

212. Credits for charges against vendors for returned materials, shortages, defective items, etc.

It should be determined that all charges for materials returned to vendors, shortages, defective items, etc., have been properly credited to the Government.

213. Interest on advance funds.

Where the contract provides for interest to be paid for funds advanced by the Government, it should be determined by the auditor that such charges have been properly calculated and reflected in the final settlement.

214. Penalties applicable to contractor.

When the contractor has defaulted in the performance of the contract and under the terms of the contract a penalty has been established by the contracting officer, it should be determined by the auditor that this charge is incorporated in the final settlement.

215. Insurance premiums directly charged to contract.

a. It should be determined that all necessary steps have been taken to cancel insurance policies and bonds or discontinue special rating methods used because of Government interest and to obtain pro rata refund of unearned premiums or proper premium adjustments where insurance has been written under either the War Department Insurance Rating Plan or the War Department Group Insurance Rating Plan.

b. The auditor should determine that all refunds and dividends have been reflected in the settlement with the contractor, and where claims exist for amounts not yet received that such claims have been assigned to the Government.

216. Government-owned property connected with contract.

a. Instructions in regard to accounting for Government property at contract termination are set forth in TM 14–1010, Property Audit Procedures, Continental U. S., formerly section X of the War Department Industrial Property Accounting Manual, 16 February 1943. The auditor should cooperate with the accountable property officer and assist him in carrying out his functions with respect to termination.

b. Where Government property is disposed of by the contractor in accordance with the terms of the contract (see PR 363 and 727), the auditor should determine that all of such dispositions are approved by the contracting officer and that the amounts involved are properly reflected as credits against contract costs.

c. Where unsettled charges are outstanding against the contractor for loss, damage, or destruction of property under the provisions of TM 14–1010, formerly the Industrial Property Accounting Manual, such charges should also be properly reflected in the final settlement.

217. Materials received or services rendered and not billed.

a. Every effort should be made by the contractor prior to the final settlement to secure invoices from vendors for materials received or services rendered and not billed.

b. Where billing was not received, a list should be prepared by the contractor showing the date material or service was received, receiving report number (where applicable), vendor's name, and other pertinent information.

218. Uncompleted purchase orders.

The contractor should prepare a list of all purchase orders pertaining directly and solely to the contract which have not been completed, and which have not been covered by termination settlements. This list should show: date; purchase order number; vendor's name; quantities, descriptions, and prices of each item ordered; quantities received; and reasons or explanations, if any, as to why the purchase order was not completed. This list should be supported by copies of purchase orders bearing the usual approvals by contractor personnel.

219. Other known liabilities.

The contractor should prepare a list of all other known liabilities pertaining directly and solely to the contract. This list should show date, name, description, amount, and other pertinent information which might be of value to the Government.

220. Items disallowed and not reimbursed to contractor.

The contractor should prepare a report listing all items disallowed during the operation of the contract and not reimbursed by the Government. Such lists should show dates expenditures were made, amounts, and appropriate explanations.

221. General accounting office exceptions.

a. Every effort should be made by the contractor, contracting officer, and auditor prior to final settlement to clear all known outstanding exceptions issued by the General Accounting Office.

b. In the event there are exceptions outstanding at the time of final judgment, and in the opinion of the contracting officer the interest of the Government would not be jeopardized by making the final payment, the following certificate may be executed for submission to the finance officer (see Finance Bulletin No. 55, 20 May 43):

> Notices of exception received on contract No. _____ can and will be replied to, giving the information required by the General Accounting Office, and I further certify that to the best of my knowledge and belief the interest of the United States will not be jeopardized by the making of this final payment.
>
> _____
> Contracting officer or his representative

c. In other cases where exceptions received clearly indicate the probability of charges against the contractor, the estimated amount of the charges should be withheld from the settlement pending further investigation and definite determination of the final charge to be made.

222. Calculation and payment of fixed fee.

The amount of the prime contractor's fixed fee due and unpaid to the effective date of the termination notice will be computed, adjusted, and paid in accordance with the terms of the terminated contracts. (See PR 15–651.9.)

223. Form of closing statement.

A closing statement in the following form should be prepared by the contractor showing the balance due the contractor on completion or termination of any CPFF contract. (See PR 15–655.)

_____ 194____

Contractor _____
Work covered by contract _____
Contract No. _____ Date of Contract _____ 194____

A. Fixed fee due:
  1. Total fixed fee allowed for work actually done (per attached schedule) -- $_____
  2. Less payments to contractor to date on account of fixed fee (per attached schedule) _____ _____
  3. Unpaid balance of fixed-fee _____ _____
  4. Costs under the contract not yet claimed (per attached schedule and documentary evidence) _____

  Total _____ $____

B. Less:
  1. Property not accounted for to property accountable officer (per statement herewith) _____ $____
  2. Other items chargeable to contractor (per detailed statement herewith) _____ _____
  3. Proceeds from sale of Government property where such disposition authorized by the contract (per attached statement herewith) _____ _____
  4. Unliquidated balance of advance payment fund____ _____

  Total deductions_____ _____

C. Balance due contractor_____ $____
D. Amount withheld pending clearance of suspensions___ _____
E. Balance payable to contractor or balance due Government as of this date_____ $____

SECTION III

ADDITIONAL PROCEDURES FOR FINAL SETTLEMENT APPLICABLE IN 100 PERCENT CPFF PLANTS WHERE ALL CPFF CONTRACTS ARE TERMINATED

224. Deposits.

a. The contractor should prepare a list of all unclaimed deposits for tools, containers, clothing, badges, etc., showing date and nature of deposit, amount, and badge or employee number.

b. It should be determined by the auditor that the list is accurate and that the Government has been credited with the proper amounts.

225. War savings bond deposits.

a. The contractor should prepare a list of all unclaimed war savings deposits of employees, prepare a check drawn to the Treasurer of the United States for this amount, and transmit it through the auditor to the disbursing officer for the contract involved.

b. The auditor should satisfy himself as to the accuracy of the list by—

(1) Obtaining the bank statement directly from the bank and preparing final reconcilement of the ledger accounts with the amount of the contractor's check.

(2) Test checking entries to contractor's ledger accounts.

c. A list should also be prepared by the contractor covering all bonds not delivered to the contractor's employees showing name, bond number, and amount. This list in triplicate with the bonds attached should be transmitted through the contracting officer to the Treasury Department. Additional copies of the list should be provided so that the auditor and contractor may each retain a copy receipted by the Treasury Department.

226. Outstanding taxes—State and Federal.

Where social security or other taxes cannot be paid until the end of a specified period and final settlement is made during the period, all returns should be prepared by the contractor and reviewed by the auditor.

227. Cafeterias, commissaries, canteens, etc.—contractor-operated.

a. A final report should be prepared by the contractor covering all operations not covered in previous reports and an audit thereof will be made in the manner set forth in section 5, chapter 3, TM 14–1000, now paragraphs 305.1 through 305.5 of the Manual for Administrative Audit of Cost-Plus-A-Fixed-Fee Supply Contracts.

b. It should be determined that credits from any sales of supplies have been properly applied and that the final net gain or loss is properly included in the final settlement.

228. Cafeterias, commissaries, canteens, etc.—concessionnaire-operated.

A final report should be obtained from the concessionnairs, and a determination made that all amounts due have been received and properly included in the final settlement.

SECTION IV

ADDITIONAL PROCEDURES FOR FINAL SETTLEMENT APPLICABLE IN ALL CASES IN MIXED PLANTS

229. Overhead.

a. As a general rule, for purposes of determining the contract overhead rate, the overhead accounts should be closed as of the end of the month in which the contract (or contracts) is terminated. In this closing of the overhead accounts, appropriate adjustments should be made in the same manner as would be made at a year end closing, except that it is not necessary to incorporate such adjustments in the formal book records.

b. In cases where the contract (or contracts) being terminated does not represent a substantial proportion of the total business of the contractor or of the CPFF work, the requirements of inventories relating to overhead, as set forth in TM 14–1010, formerly the War Department Industrial Property Accounting Manual, and other adjustments may be waived, with the approval of the contracting officer, and overhead applicable to the CPFF contract terminated may be settled on an approximate basis.

c. The auditor should review the final overhead statements in a manner similar to his usual audit of overhead.

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ADMINISTRATIVE AUDIT PROCEDURES FOR COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

INSTRUCTIONS FOR REVISION

Contents page to replace contents page dated 1 Mar 44.
Insert text of chapter 5 following page 71 of TM 14–1000, 1 Mar 44.

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CONTENTS

	Paragraphs	Page
Chapter 1. Introduction.		
Section I. General	1–12	1
II. Reimbursement policies	13–14	3
III. Documentary evidence requirements of General Accounting Office	15–30	3
Chapter 2 Review and appraisal of contractor's procedures.		
Section I. General survey	31–32	8
II. Accounting policies of contractor	33–37	8
III. General nature of internal control	38–44	10
IV. Outline of procedure for review and appraisal of internal control	45–48	12
V. Invoices	49–60	12
VI. Pay rolls	61–74	15
VII. Journal entries	75–82	17
VIII. Miscellaneous	83–90	19
Chapter 3. Application of selective audit procedures.		
Section I. Introduction	91– 99	21
II. Invoices	100–110	23
III. Pay rolls	111–116	26
IV. Journal entries	117–125	28
V. Miscellaneous	126–133	31
Chapter 4. Final settlement of cost-plus-a-fixed-fee supply contracts.		
Section I. General	201–207	61
II. Procedures for final settlement which have general applicability	208–223	63
Section III. Additional procedures for final settlement applicable in 100 percent CPFF plants where all CPFF contracts are terminated	224–228	66
IV. Additional procedures for final settlement applicable in all cases in mixed plants	229	67
Appendix		69
Chapter 5. Cost interpretations.		
Section I. Scope, purpose, and application	230–232	73
II. Application of overhead to contract costs	233–241	75
III. Direct labor overtime and shift premiums	242–245	79
IV. Entertainment	246–249	81
V. Fees of professional accountants	250–252	83
VI. Compensation of directors	253–254	85
VII. Depreciation and amortization	255–259	87
VIII. Employee bonuses	260–262	89
IX. Contributions to charitable or community organizations	263–267	91
X. Interdivisional transfers	268–269	93
XI. Annuity premiums paid in connection with a group retirement annuity plan	270–274	95
XII. Attorneys' fees	275–280	97
XIII. Federal capital stock tax	281–285	99
XIV. Advertising	286–289	103
XV. Profit or loss from cafeterias, dining rooms, sales stores, vending machines, etc.	290–295	105

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CHAPTER 5

COST INTERPRETATIONS

SECTION I

SCOPE, PURPOSE, AND APPLICATION

230. These cost interpretations are issued for the information and guidance of the contracting officer, but are not intended to control or direct the exercise of the authority given him by the contract to determine what costs are reasonable and are incident and necessary to the performance of the contract.

231. In all instances the specific terms of the contract will govern, and these cost interpretations may be given consideration only where the contract is silent, vague, or ambiguous as to the subject matter of the cost interpretation.

232. These cost interpretations are not intended to provide factual yardsticks for the computation of costs incident to and necessary for the performance of any particular contract. They deal essentially with the meaning of terms of a technical or commercial nature relating to costs and indicate the usual interpretation of such terms where used in standard forms of contracts, subject to the consideration by the contracting officer of the specific facts before him in the light of the terms of the particular contract involved. They are intended to be consistent with the principles for determination of costs contained in Treasury Decision 5000, paragraph 26.9, as approved by the Secretary of War, 6 August 1940, and are interpretations of the cost provisions of cost-plus-a-fixed-fee contracts embodying such principles or principles substantially similar thereto.

SECTION II

APPLICATION OF OVERHEAD TO CONTRACT COSTS

233. Summary.

Overhead rates are to be based on the period during which the contract is performed when fractions of fiscal years are involved; a consistent classification of costs as between direct charges and overhead must be followed throughout the entire life of the contract; departmental rates are preferable but not invariably essential.

234. Definitions.

a. Overhead costs are defined for the purpose of this cost interpretation as those costs which are not charged directly and finally to the contract in the first instance but are first charged to departments, burden centers, or other overhead units, the costs of which are subsequently apportioned to a particular CPFF contract and to other such contracts or other work such as fixed price contracts or commercial work.

b. Overhead as a general term refers to factory indirect expenses, engineering indirect expenses, and administrative expenses.

c. Direct costs are defined as those costs which, in the first instance of their distribution as costs, are charged directly and finally to the contract without any intermediate distribution to an overhead unit.

235. Overhead percentages.

a. As a general rule, overhead will be charged to contract costs through the use of pencentages to appropriate bases. Factory overhead is commonly applied as a percentage of factory direct labor dollars. Engineering overhead (production engineering) is usually applied as a percentage of engineering direct labor dollars. Administrative expenses may be applied as a percentage of total manufacturing costs.

b. Factory overhead may be applied on any other acceptable basis such as in the form of machine hour rates, or rates per direct labor man-hour. Machine hour rates are ordinarily essential only when more than one direct worker operates a machine and the size of the crew varies with the type of work or when one operator handles more than one machine but a varying number of machines are operated. Factory overhead is usually more equitably applied on the basis of machine hours where direct labor is a relatively minor part of cost and where depreciation, repairs, supplies, and maintenance of machinery are relatively large. The use of an overhead rate per direct labor hour as contrasted with a percentage of direct labor dollars is usually necessary only when there are wide variations in the rates of pay for the same kind of work or other variations which have no significance in relation to the incidence of overhead. However, the use of machine hour rates, or labor hour rates does not obviate the necessity of a proper departmental classification as described under paragraph 237 *a* and *b*. While very high overhead rates may not necessarily be incorrect, all such rates should be given special attention.

236. Overhead period.

a. In most cases, rates computed on an annual basis will be acceptable and it will not be necessary to compute monthly rates. However,

if the proportion of CPFF work to the total work is not substantially constant during the year and there are at the same time appreciable fluctuations in the rates of overhead during the year, consideration will be given to the necessity of computing overhead on a monthly basis to determine the proper cost of the contract. Whenever monthly rates are used, they must accurately reflect accruals of costs and while year-end adjustments should not be of major amounts, such adjustments as occur should be made effective with reasonable accuracy in the monthly rates.

b. When a contract is in effect for a portion of a fiscal year, the overhead rates will be based on the period including the first month and the last month in which work was performed. If two or more fiscal years are involved, a final overhead settlement will be made as of the end of each fiscal year. If rates are computed for a fractional fiscal period as a whole rather than monthly rates, the provisions of *a* above will apply to the fractional period in the same manner as if it were a whole year. For example, if a 14 months' overhead period is involved which includes the last 8 months of 1942 and the first 6 months of 1943, two average overhead rates may be used, one for the first 8 months and another for the succeeding 6 months' period. These overhead rates will be subject to applicable adjustments at the end of each fiscal year. Consideration will also be given to the use of monthly rates for either or both overhead periods in accordance with *a* above.

237. Departmental rates.

a. Whether departmental rates (or burden center rates) are necessary for the correct application of overhead as contrasted with the use of one over-all plant rate is a matter to be determined in individual cases. The variety of products and processes in the mixed plant, the proportion of work done on each product in the various sections of the plant, and variations in rates of production are factors which should be taken into consideration. Departmental rates are ordinarily preferable but are not invariably essential.

b. The existing departmental classification may become inadequate because of changed conditions. For example, parts for the contract may be processed entirely by bench work in a department having expensive machinery. In such a case a further subdivision of the department may be necessary.

c. While the comments in *a* and *b* above refer primarily to factory overhead, the same principles apply to engineering and administrative overhead. The necessity of departmentalization must be considered and reviewed from time to time to give effect to changing conditions.

d. No attempt is made to outline herein in detail the principles to be followed in prorating the expenses of indirect or general departments to direct departments. However, the fundamental requirement is that the bases used must result in a proration which measures with reasonable accuracy the services or benefits received by the direct department to which the proration is made. Proration should not be made on the basis of "normal," "readiness to serve," or other such arbitrary factors. Ordinarily, the allocation of *all* indirect or general factory expenses to the direct departments on the basis of the direct labor dollar pay rolls is not acceptable. General factory expenses may include, for example, depreciation of machinery and equipment which does not necessarily have any relation to the amount of direct labor in the various departments.

e. In the case of existing contractor-owned facilities, the application of fixed charges such as depreciation and property taxes may commence with the date when conversion of the plant is started or operations commence. In the case of new facilities furnished by the contractor, depreciation may be charged from the date of completion of buildings or the date of installation of machinery respectively. Property taxes may be charged on a prorata basis from the date such taxes became a lien.

238. Consistency.

a. Consistency in the application of accounting policies is necessary to the accurate determination of costs. In this respect, it is essential that the same bases (proportionate direct labor dollars or hours, etc.) for the proration of overhead to the contract be followed in a particular overhead unit (plant, department, or burden center) throughout the *entire* performance of the contract. It is also similiarly essential that the same types and classes of costs be treated as direct charges or as overhead uniformly throughout the *entire* performance of the contract.

b. If any part of the cost of performing a particular function or activity is treated as a

direct charge to the contract then no part of such cost is to be included in overhead.

c. When costs of the type usually charged to overhead are charged directly to the contract, it is essential that a thoroughly reliable basis exist for determining the charge and that it be susceptible to satisfactory check.

d. An attempt should not be made to charge directly relatively small items of cost which are ordinarily charged to overhead. Such a procedure is economically unsound since the cost of the work involved is disproportionate to the apparent gain in accuracy.

239. Idle and excess facilities.

a. Care should be exercised to exclude from overhead any costs resulting from idle and excess facilities which are not now necessary and will not be necessary for the performance of the contract after considering reasonable standby requirements. When departmental rates are used, the prorations of general factory expense as well as direct departmental costs should be examined for possible inclusion of such costs.

b. Widely varying monthly production volumes tend to produce wide fluctuations in monthly overhead rates because of fixed charges. The determination as to whether idle, excessive, and unnecessary capacity exists in relation to the volume of production, and which would require the exclusion of the related fixed charges, is to be made on the basis of a study of such variations over an annual period.

240. Engineering overhead (indirect expenses).

a. The provisions of paragraph 238 are for application to engineering overhead.

b. The engineering overhead referred to here is that of "production engineering," that is, the overhead consisting of supervision, drafting supplies, maintenance and repair of engineering equipment, etc., relating to the engineering direct labor involved in work directly chargeable to the contract such as the designing of tools and preparations of routing sheets and working drawings.

c. Engineering costs such as are involved in research work and development of new products are not includible in the engineering overhead described in the preceding paragraph.

241. Administrative overhead.

a. The provisions of paragraph 239 are for application to administrative overhead.

b. T. D. 5000 provides that administrative expenses shall *ordinarily* be allocated or distributed to the cost of performing a contract on the basis of the proportionate manufacturing, installation, and construction cost. This basis is acceptable only if it is appropriate in the particular circumstances and any other basis may be used if it results in a more equitable charge to the contract.

c. Direct charges to the contract will not be allowable in mixed plants for items of cost *customarily treated in commercial practice* as a part of administrative overhead unless specific and clear evidence is presented that appreciable inaccuracies in cost determination will result from prohibiting this procedure.

SECTION III

DIRECT LABOR OVERTIME AND SHIFT PREMIUMS

242. Summary.
Direct labor overtime and shift premiums are not to be charged solely to work done in overtime hours.

243. Overtime premiums do not apply solely to the work done in the overtime hours, but rather to the work done within the entire period which is the basis for determining the amount of overtime worked.

244. Similarly shift premiums apply to all work done in a particular department or other overhead unit within the pay-roll period since they arise because of the total number of daily hours operated including all shifts.

245. The provisions of paragraphs 243 and 244 are met if the overtime and shift premiums are included in factory overhead.

SECTION IV

ENTERTAINMENT

246. Summary.
Entertainment expenses are not allowable. Group meals for employees in connection with business meetings and expenses in connection with events designed to stimulate employee morale such as "E" award celebrations are not necessarily entertainment.

247. Expenses which are *solely* in the nature of entertainment are not allowable.

248. Meals purchased and expenses incident to group meetings of a business nature for employees are allowable provided information is submitted as to the purpose and nature of the meeting including the number of employees present.

249. Expenses of events which are designed to stimulate the efforts of employees toward increased production or similar objectives such as celebrations in connection with "E" awards are allowable.

SECTION V

FEES OF PROFESSIONAL ACCOUNTANTS

250. Summary.

Fees of professional accountants in connection with normal and customary services, including periodic audits, are reimbursable. Certain other fees are not reimbursable.

251. Fees of professional accountants incurred in connection with normal and customary accounting services, including the periodic audits of the contractor's accounts, the preparation of regular stock exchange, and S. E. C. reports and Federal income-tax returns represent reimbursable costs.

252. Fees are not reimbursable when incurred in connection with reorganizations, security issues, capital stock issues, negotiation of contracts with the Government, and prosecution of claims against the Government (including income-tax matters).

SECTION VI

COMPENSATION OF DIRECTORS

253. Summary.
Allowable, as a general rule.

254. Compensation of directors and reimbursement for traveling expenses are allowable as cost as a general rule.

SECTION VII

DEPRECIATION AND AMORTIZATION

255. Summary.
As a general rule, the rates claimed for Federal income-tax purposes will be considered as maximums; appropriate depreciation of facilities covered by certificates of necessity will be allowed but not on the basis of amortization permitted for Federal income-tax purposes.

256. For the purpose of reimbursement the rates of depreciation and amortization will, as a general rule, not be in excess of those claimed in the Federal income-tax returns of the contractor.

257. Amortization of emergency facilities covered by certificates of necessity will not be allowed on the basis established for income-tax purposes but depreciation on such facilities at appropriate rates will be reimbursable. The rates used must be justified by the contractor and should be compared with those taken on similar facilities not covered by certificates of necessity. If such a comparative basis is not available, the rates published by the Bureau of Internal Revenue in Bulletin F will be used as a guide by the auditor in considering the propriety of the rates claimed but consideration may be given to the effect of multiple shifts and other pertinent conditions.

258. If the rates claimed in the current year's tax return have been increased over the approved rates in the return for the most recent year which has been closed, such increases must be specifically justified by the contractor. Unless the justification is clear, consideration will be given to the disallowance of part or all of the depreciation due to the increased rates.

259. In any special situation, where depreciation in excess of the rates used in the Federal income-tax return is claimed by the contractor and it appears that limitation to the tax rates would not be equitable, the facts will be submitted for the information of higher authority of the service involved or Army Air Forces who, in important cases, will advise the Fiscal Branch, Washington, of Army Air Forces or the service involved.

SECTION VIII

EMPLOYEE BONUSES

260. Summary.

Bonuses to employees, including officers, are allowable as a general rule but subject to certain conditions; must not be based upon the amount of profits.

261. Bonuses to employees represent a part of the employee's total compensation and are a reimbursable cost subject to the following conditions:

a. The bonus must not be restricted to officer or other employee stockholders and the basis of distribution must have no relation to individual or group stockholdings.

b. The contractor's policies in respect to payment of bonuses must be presented in writing to the contracting officer's representative.

c. The payment of the bonuses must not be based upon the amount of profits made by the contractor.

d. The bonus must be for services rendered.

e. Limitations on total compensation, as specified in the contract, must be complied with.

262. The bonus payments may include production incentives, prizes for suggestions, safety awards, and Christmas gifts and may be paid either in cash or merchandise.

SECTION IX

CONTRIBUTIONS TO CHARITABLE OR COMMUNITY ORGANIZATIONS

263. Summary.
Allowable when made to recognized charitable, religious, scientific, or educational organizations.

264. The contractor will normally be called upon to make contributions to charitable and community organizations.

265. Such contributions will constitute reimbursable costs when made to charitable, religious, scientific, or educational organizations which are "recognized" as such by the Treasury Department.

266. In determining whether a contribution is reasonable in amount, the contracting officer should give consideration both to past policies of the contractor and the expanded scope of the contractor's current activities.

267. Contributions to so-called "national" organizations are allowable if the organization either solicits its funds locally or the local area receives funds or benefits therefrom.

SECTION X

INTERDIVISIONAL TRANSFERS

268. Summary.

When purchases are made by one division of a contractor from another division of the same contractor, the amount allowable as reimbursable cost shall not include any profit.

269. In the performance of a CPFF contract by the contractor, certain materials or parts will frequently be obtained from one division of the contractor to be used in another division. Such divisions may operate much like separate companies and transfers between them handled through interdivisional billings. Any billings of this kind are not to include a profit for the originating division but are to be transferred at actual cost, unless otherwise specifically provided by the terms of the contract.

SECTION XI

ANNUITY PREMIUMS PAID IN CONNECTION WITH A GROUP RETIREMENT ANNUITY PLAN

270. Summary.
Reimbursable for amounts applicable to the contract period subject to limitations and conditions specified below.

271. Premiums paid to an insurance company by the contractor for present services under a group retirement annuity plan, providing for annuities to employees upon retirement or death, are reimbursable provided—

a. The retirement annuity plan is actuarially sound; that it applies to a representative number of contractor's employees; that there is no indication that the plan has been devised primarily for officer or employee stockholders; and that premiums paid cannot be interpreted as a distribution of profits.

b. The premiums paid by the contractor are not recoverable by the contractor or are recoverable only as a credit against future premiums.

272. When the group annuity retirement plan is initiated while CPFF work is in progress, premiums applicable to "past services" of the employee, that is, services prior to the date of the annuity plan, are *not* allowable.

273. When the group annuity retirement plan was in effect prior to the date of the CPFF contract, only those premiums are allowable which apply to services coincident with the performance of the contract. In other words, no portion of the premiums applicable to services prior to the incidence of CPFF work can be applied to the contract costs.

274. Premiums are allowable only if the yearly premium applicable to an individual employee, when added to his other compensation, does not exceed the maximum compensation which may be specified by the contract as reimbursable for any one employee.

SECTION XII

ATTORNEY'S FEES

275. Summary.
Attorney's fees for services performed in connection with the work under the contract may be reimbursed under certain conditions.

276. A.R. 410–5 and War Department Circular No. 263, 5 August 1942, require contractors in certain cases to utilize the services of The Judge Advocate General's Department or the Department of Justice. The contracting officer in other cases may require the contractor to utilize such services.

277. In cases other than those referred to in paragraph 276, and in the absence of a specific contract provision to the contrary, a cost-plus-a-fixed-fee contractor may be reimbursed for attorneys' fees to the extent the services are necessary and relate to the performance of the work under the contract, provided the services are in a matter where there is no conflict of interest between the contractor and the Government.

278. Such services include, but are not limited to—

a. Services in connection with a tax or wage claim against the contractor which, if proved and paid, would be reimbursable in whole or in part by the Government.

b. Services in defense against a claim arising from injury to persons or damage to property in connection with the performance of the contract and directly attributable thereto, which claims, if proved and paid, would be reimbursable in whole or in part by the Government.

c. Services in connection with the procurement of supplies, services, and facilities directly related to the work under the contract.

d. Counsel concerning laws, rules, and regulations which are or may be applicable to the performance of the contract, when such counsel benefits the Government.

279. When reimbursement for such fees is claimed, a brief description of the nature of the services should be attached to the voucher.

280. Fees incurred by the contractor for his sole benefit, such as for the negotiation of contracts with the Government and for prosecution of claims against the Government, are not reimbursable. Similarly, fees incurred in connection with such general matters as capital stock issues and corporate reorganizations are not reimbursable. Retainer fees of a general nature, including those where it is not practicable to identify the extent to which the interests of the Government are served, are also not reimbursable.

SECTION XIII

FEDERAL CAPITAL STOCK TAX

281. Summary.
Reimbursable for the amount applicable to the contract subject to the limitations specified below.

282. Section 1200 (*a*) of the Internal Revenue Code provides:

"Domestic Corporations—For each year ending June 30, beginning with the year ending June 30, 1939, there shall be imposed upon every corporation with respect to carrying on or doing business for any part of such year an excise tax of $1.25 for each $1,000 of the declared value of its capital stock.

(Underlining supplied.)

283. The measure of the amount of capital stock tax paid is the "declared value," and the contractor may declare any amount he deems proper.

284. The capital stock tax has been held to be an excise tax for the privilege of doing business as a corporation (*Flint* v. *Stone Tracy Company*, 220 U. S. 107). As a necessary cost of doing business it is a proper reimbursable cost.

285. The maximum amount of capital stock tax reimbursable is to be determined as follows:

a. The amount of tax paid shall be prorated in equal amounts per month over the contractor's first income tax year ending subsequently to the last day of the capital stock tax year. For example, if the contractor's income tax year ends on 31 December 1943, the capital stock tax referred to is the tax payable on 31 July 1943.

b. The amount prorated under *a* above shall not exceed the amount of tax calculated on 10 times the net income for declared value excess-profits tax computation for such income tax year.

c. Any allocation of capital stock tax to the contract and to other work shall be made on the same basis as other general administrative expenses.

d. The amount allocable to the contract for the contractor's income tax year shall not exceed the lower of:

(1) The amount of tax calculated on 10 times the profit on the contract for such income tax year. For example, if the contractor's income tax year ends on 31 December 1943, and the profit on the contract for such year is $100,000, the amount of Federal capital stock tax which would be an allowable cost for such year cannot exceed $1,250 ($100,000×10×.00125).

(2) The proportion of the tax paid that the profit on the contract for the income tax year bears to the net income for declared value excess-profits tax computation for such income tax year.

e. In the determination of the foregoing limitations any subsequent change in the ap-

plicable statutes shall be reflected in the rates used for capitalizing the earnings and for the calculation of the tax thereon.

f. The amount of profit applicable to the contract for the income tax year is to be determined on a basis consistent with that used by the contractor in the determination of his net income for declared value excess-profits tax computation. The profit applicable to the contract will be considered to be the amount of fee taken into income for income tax purposes less any charges attributable to the contract which are not reimbursable under the particular terms of the contract.

g. The applicability of the limitations prescribed herein is to be determined in connection with the audit of the year-end overhead statements prescribed in paragraph 125.

SECTION XIV

ADVERTISING

286. Summary.

As a general rule advertising is not a reimbursable cost. However, the cost of advertising of an institutional character placed in technical journals may be reimbursed.

287. As a general rule advertising is not a reimbursable cost.

288. Advertising of an institutional character (as contrasted with the advertising of products for sale), placed in technical journals, primarily for the purpose of offering financial support to such journals because they are of value for the dissemination of technical information for the industry, is a reimbursable cost.

289. This cost interpretation does not apply to expenditures for newspaper space, radio time, and other media in connection with employment and other personnel activities.

SECTION XV

PROFIT OR LOSS FROM CAFETERIAS, DINING ROOMS, SALES STORES, VENDING MACHINES, ETC.

290. Summary.

Subject to the specific terms of the contract, profits will be credited to costs unless irrevocably set over to a company welfare organization for the benefit of employees. Losses may be reimbursable if the activity is not primarily for the benefit of a limited group and if any profits therefrom are credited to costs.

291. Subject to the specific terms of the contract, profits accruing to the contractor from the operation of cafeterias, dining rooms, soda fountains, sales stores, vending machines, etc., operated by the contractor or by a concessionaire will be treated as a credit to costs of the contract except for activities from which the profit is irrevocably set over to a company welfare organization in amounts reasonably usable for the benefit of the employees at the particular location.

292. Subject to the approval of the contracting officer, losses in reasonable amount incurred on any of such activities may be reimbursable provided—

a. The operation is not primarily for the benefit of a limited group, such as an executives' dining room,

b. That any profits from the operation are credited to costs.

293. The terms "profit" and "loss" as used herein refer to the profit or loss of a particular activity for the contractor's fiscal year or portion thereof in which the activity is involved. The accounting records are to be maintained in such a manner that the loss of executive or other restricted patronage operations (which are not reimbursable under the terms of par. 292*a*) can be readily determined.

294. If profits are irrevocably set over to a company welfare organization, such organization will be charged with its proper share of expenses related to the activities from which the profit is obtained. These charges will include a rental charge for Government-owned equipment and a charge for any space occupied in a Government-owned facility.

295. In the case of plants which are "mixed" in character, that is, having work other than CPFF contracts, the profit or loss will be reflected in appropriate overhead accounts of the contractor. In the case of plants having only CPFF contracts, the profit or loss will be allocated directly to the contracts involved.

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TECHNICAL MANUAL

ADMINISTRATIVE AUDIT PROCEDURES FOR COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

CHANGES No. 1

WAR DEPARTMENT,
Washington 25, D. C., 1 May 1944.

TM 14-1000, 1 March 1944 is changed as follows:

Paragraph 11a, page 3, change the word "contractor" at the end of the first sentence to "contract."

Paragraph 38c, page 10, change the word "chapter" to "section" and "chapters" to "sections."

Paragraph 74b, page 17, delete the words "and should contain a statement by the contracting officer, or his authorized representative, that deposit of the deductions has been verified."

Paragraph 99a, page 22, delete words "the Manual for Administrative Audit of Cost-Plus-A-Fixed-Fee Supply Contracts" and add "this Manual."

Paragraph 202, page 61, change section 2 to section II.

Paragraph 203a, page 62, change "TM 14-1006, Administrative Accounting Procedures, Fixed-Price Supply Contract Terminations, now published as" to "TM 14-1005, 'Termination Accounting Manual for Fixed-Price Supply Contracts' now being published to supersede."

Section II, page 63, change first word in title to "Procedures."

Paragraph 216a, page 64, delete reference to TM 14-1010 and the word "formerly." Add the words "as amended" after 16 February 1943.

Paragraph 216c, page 64, delete words "TM 14-1010 formerly the" and add "section X of the War Department."

Paragraph 221b, page 65, substitute the word "settlement" for the word "judgment" in line 2.

Paragraph 241a, page 77, change 239 to 238.

Remove pages 31 and 32 and substitute revised page 31 and page 32 herewith.

Remove page 66 and substitute revised pages 66 and 67 herewith.

[A. G. 300.7 (22 Apr 44).]

BY ORDER OF THE SECRETARY OF WAR:

G. C. MARSHALL,
Chief of Staff.

OFFICIAL:

J. A. ULIO,
Major General,
The Adjutant General.

DISTRIBUTION:

As prescribed in paragraph 9*a*, FM 21-6; Armies (10); Corps (10); Dept (10); T of Opns (10); B (2); C 14 (5).

For explanation of symbols, see FM 21-6.

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tor must consider the necessity of a suitable adjustment in the year-end overhead settlement.

d. The auditor should determine that important charges to overhead represented by liabilities at the year-end have been liquidated by actual payments since the year-end date. In accomplishing this objective, he should make sure that—

(1) The contractor's books have been closed.

(2) Sufficient time has elapsed to establish the accuracy of liabilities shown at the year-end.

(3) A copy of the public accountant's report or other annual report of the contractor is available for examination.

e. Comparisons will be made between Federal tax returns and the books to ascertain major differences in accounting policies.

f. After the books have been closed, the auditor will obtain an analysis of the changes in surplus during the year to determine whether any credits should be applied to the cost of the contract.

g. The auditor will consider the desirability of examining the minutes of the stockholders', directors', and executive committee meetings, particularly in cases where the CPFF contracts represent the major proportion of the contractor's business.

SECTION V
MISCELLANEOUS

CAFETERIAS, COMMISSARIES, CANTEENS, ETC.

126. Introduction.

a. The purpose of the auditing procedures relating to cafeterias, commissaries, and canteens is to establish the credibility of the accounts, to ascertain that proper controls are in operation with regard to inventories and cash, and to determine that the net income from operations has been applied against the costs of the contract. These procedures may also be applied to the audit of cafeterias operated by concessionaires.

b. The procedures specified in this manual with respect to cash disbursements for pay rolls, invoices, etc., will, in general, be applicable. Those instructions will be followed to the extent practicable in conjunction with the special procedures set forth in this chapter.

c. The audit program will be based upon the findings made in the review of the internal procedures, and will be adjusted to current findings.

127. Invoices, pay rolls, etc.

a. A representative number of invoices will be examined to determine that they are approved for prices and receipt of merchandise by responsible persons.

b. A representative number of pay rolls will be examined to check the number of employees, rates of pay, and approval by responsible persons.

c. A representative number of cash disbursement entries will be supported by paid invoices, petty cash vouchers, pay rolls, etc.

128. Control of inventories.

a. Where perpetual inventories are maintained, the auditor will determine that the inventories are being properly relieved of the cost of items withdrawn and losses through spoilage.

b. The auditor will check the physical inventories at appropriate intervals. This may be accomplished through supervision of the taking of inventories by contractors' employees.

129. Cash receipts and control of revenue.

a. The auditor will determine that receipts are being properly recorded at time of sale.

(1) A representative number of sales checks or tickets should be compared with cash register tapes.

(2) If a food checker is maintained, a representative number of day's cash receipts, as recorded, will be reconciled to the food checker's control totals.

b. Cash receipts as recorded at time of sale will be traced to book records.

(1) Compare totals of cash register tapes or other records with daily cash receipts recorded for a representative period.

(2) Check daily receipts to bank deposits for a representative period.

(3) Reconcile bank account if a separate bank account is maintained.

c. Compare statistics such as percentages of food costs to sales, expense ratios, etc., with ratios for previous periods.

d. In the event that costs of food and service appear to be excessive, explanations thereof should be obtained.

e. Where dormitories are operated, the rental charges and the collection of revenue should be compared with records of occupancy of rentable rooms for representative periods to determine that all revenue is properly credited.

f. Appropriate checks will be made to ascertain that commissions from concessionaires are being received in accordance with the terms of the concessionaire's contract and are being applied according to approved accounting policies.

130. General.

a. The auditor will trace the postings from cash receipts and cash disbursements records to the general ledger for representative periods.

b. The individual items shown on the contractor's summary reports will be traced to the general ledger.

c. The accuracy of the summary statements will be checked and the application of the net balance to the cost of the contract will be verified.

SCRAP

131. Introduction.

The objective of the audit procedures with respect to scrap is to determine that scrap resulting from materials and supplies charged to the contract is adequately controlled so that the proper credit is obtained by the Government. The program will be based upon the results of the review of internal control and will be adjusted in accordance with current findings.

132. Accumulation and care of scrap.

a. The auditor will carefully survey the source from which scrap originates and where practicable will ascertain from engineering estimates and operating records the quantities normally derived from the various operations. The actual results should be compared and an significant variations investigated.

b. The physical and accounting controls over stores of scrap will be studied to determine whether the interests of the Government are being adequately protected.

133. Disposition of scrap.

a. Quantities disposed of should be compared with quantities obtained from operations and with stocks still on hand to determine that all scrap is being accounted for.

b. All sales or other disposition should be checked to determine that credits therefrom are properly applied as a reduction of the cost of the contract.

c. In cases where it is not practicable physically to segregate scrap applicable to the contract, the bases of allocation should be reviewed to determine whether they are equitable and accurately applied.

Chapter 4 (pars. 201 to 229) to be inserted following this page.

SECTION III

ADDITIONAL PROCEDURES FOR FINAL SETTLEMENT APPLICABLE IN 100 PERCENT CPFF PLANTS WHERE ALL CPFF CONTRACTS ARE TERMINATED

224. Deposits.

a. The contractor should prepare a list of all unclaimed deposits for tools, containers, clothing, badges, etc., showing date and nature of deposit, amount, and badge or employee number.

b. It should be determined by the auditor that the list is accurate and that the Government has been credited with the proper amounts.

225. War savings bond deposits.

a. The contractor should prepare a list of all unclaimed war savings deposits of employees, prepare a check drawn to the Treasurer of the United States for this amount, and transmit it through the auditor to the disbursing officer for the contract involved.

b. The auditor should satisfy himself as to the accuracy of the list by—

(1) Obtaining the bank statement directly from the bank and preparing final reconcilement of the ledger accounts with the amount of the contractor's check.

(2) Test checking entries to contractor's ledger accounts.

c. The contractor should prepare a list of all bonds not delivered to the contractor's employees showing the name of the bondholder and coowner or beneficiary, serial number and description of bond and any information developed in tracing nondelivery of the bond. Five copies of this list with the bonds attached should be forwarded through the contracting officer to:

Section of Investments,
Bureau of Accounts,
Treasury Department,
Washington 25, D. C.

It should be requested that two copies of the list be receipted and returned, one to be retained by the contractor and one by the contracting officer.

226. Outstanding taxes—State and Federal.

Where social security or other taxes cannot be paid until the end of a specified period and final settlement is made during the period, all returns should be prepared by the contractor and reviewed by the auditor.

227. Cafeterias, commissaries, canteens, etc.—contractor-operated.

a. A final report should be prepared by the contractor covering all operations not covered in previous reports and an audit thereof will be made in the manner set forth in section V, chapter 3, TM 14-1000, now paragraphs 305.1 through 305.5 of the Manual for Administrative Audit of Cost-Plus-A-Fixed-Fee Supply Contracts.

b. It should be determined that credits from any sales of supplies have been properly applied and that the final net gain or loss is properly included in the final settlement.

228. Cafeterias, commissaries, canteens, etc.—concessionnaire-operated.

A final report should be obtained from the concessionnairs, and a determination made that all amounts due have been received and properly included in the final settlement.

SECTION IV

ADDITIONAL PROCEDURES FOR FINAL SETTLEMENT APPLICABLE IN ALL CASES IN MIXED PLANTS

229. Overhead.

a. As a general rule, for purposes of determining the contract overhead rate, the overhead accounts should be closed as of the end of the month in which the contract (or contracts) is terminated. In this closing of the overhead accounts, appropriate adjustments should be made in the same manner as would be made at a year end closing, except that it is not necessary to incorporate such adjustments in the formal book records.

b. In cases where the contract (or contracts) being terminated does not represent a substantial proportion of the total business of the contractor or of the CPFF work, the requirements of inventories relating to overhead, as set forth in paragraph 125c, and other adjustments may be waived, with the approval of the contracting officer, and overhead applicable to the CPFF contract terminated may be settled on an approximate basis.

c. The auditor should review the final overhead statements in a manner similar to his usual audit of overhead.

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ADMINISTRATIVE AUDIT PROCEDURES FOR COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

CHANGES No. 2

WAR DEPARTMENT,
WASHINGTON 25, D. C., 1 June 1944.

TM 14–1000, 1 March 1944, is changed as follows:

Paragraph 57*e*, page 15, delete.

Paragraph 102*b*(6), page 23, delete words "telephone and transportation taxes," and add "(See Procurement Regulation 8)."

Paragraph 108*g*, page 26, delete.

Paragraph 124*i*, page 30, delete.

Remove pages 13 and 14 and substitute page 13 and revised page 14 herewith.

[A. G. 300.7 (25 May 1944).]

BY ORDER OF THE SECRETARY OF WAR:

G. C. MARSHALL,
Chief of Staff.

OFFICIAL:

J. A. ULIO,
Major General,
The Adjutant General.

DISTRIBUTION:

As prescribed in paragraph 9*a*, FM 21–6; Armies (10); Corps (10); Dept (10); T of Opns (10); B (2); C 14 (5).

For explanation of symbols, see FM 21–6.

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b. All commitments for materials and services, including utilities services, should be covered by written agreements or formal purchase orders, except for professional services such as legal, accounting, and medical.

c. Purchase orders should be complete and definite as to specifications and quantities of material, description of services, prices, discounts, transportation terms, F. O. B. point, delivery schedule, and terms of payment. They should be approved by a responsible executive of the contractor and, when required under the contract, by the contracting officer.

d. The purchase order should bear the number of the contract to which it applies.

e. Where the nature of the material is such that the trade parctice is to permit some variation between the quantity ordered and the quantity shipped, the purchase order should specify the maximum plus or minus variation.

f. Changes in quantities, specifications, terms, etc., agreed to after issuance of the original order, should be covered by approved change orders.

g. Wherever possible, purchases applicable to CPFF contracts should be made free of sales or use taxes.

h. Transportation bills should be checked against the applicable purchase order, cross-referenced thereto, and be approved by qualified personnel. They should also be checked against invoices directly or through data posted on the purchase order.

51. Receipt of materials or services.

a. Receiving reports, covering both direct and indirect materials, should be prepared by receiving department personnel who are independent of employees in the purchasing department, and in the case of direct charges to the contract, should be approved by a Government representative as to quantities.

b. Procedures should be in effect to assure that all contractor and Government inspection reports are being reviewed for rejections and that appropriate charges are made against vendors.

c. Wherever practicable, materials, after receipt in a receiving department, should be delivered to a storeroom and cleared through the stores record.

d. Invoices for utility services should be checked through independent meter readings, records of telephone calls, and other data.

52. Recording of materials in stores records.

The control of materials after purchase is not directly a part of the purchase invoice procedures. However, stores control through inventory records provides a useful check on the actual receipt of the material and the accuracy of the accounting distribution. It is therefore an important internal control procedure and should be utilized. Stores control will be further treated in section VII.

53. Invoice payment procedure.

a. Vendors' invoices should be checked by independent persons with related purchase orders and receiving reports.

b. Where more than one invoice applies to a single purchase order, information should be shown on the purchase order giving the shipments to date and the balance to be billed.

c. All invoice additions, extensions, and deductions should be checked.

d. Special care should be exercised that debit memoranda for all shortages, overpricing, and the like are deducted from the invoices of the vendor.

e. All debit and credit memoranda should be cross-referenced to the applicable invoices.

f. The deduction of all cash and trade discounts, rebates, freight allowances, and quantity discounts should receive particular attention.

g. Invoices for outside services not supported by receiving reports should be approved by a qualified executive.

h. When invoices are ready to be paid, qualified independent personnel should review their validity and the accuracy of the accounting distribution. All unallowable costs should be eliminated from charges directly or indirectly affecting the contract.

i. Payment should be approved by an independent financial executive.

54. Invoices for communication charges.

a. When telegraph charges are handled as direct charges to each contract, the following procedures should be applied:

(1) Procedures should provide for showing the contract number on all telegrams directly

chargeable to a contract at the time of transmission, so that the telegraph company can bill the charges separately for each contract.

(2) When the invoice is received from the telegraph company covering telegrams directly chargeable to the contract, the contractor, after satisfying himself as to the applicability of the messages to the contract, should execute the following certificate on the auditor's copy of the invoice.

> I certify that the messages which are listed on the attached invoice totaling $_____ are properly chargeable to the contract.
>
> *Contractor*
>
> By_____
> (Title)

b. Where telephone toll and long distance charges are handled as direct charges to each contract, satisfactory records should be maintained for the identification of such calls.

c. When telegraph and telephone toll and long distance charges are prorated to the contract through overhead, the above procedures are not applicable.

55. Invoices from CPFF subcontractors.

CPFF subcontractors should submit to the prime contractor their commercial invoices for reimbursable costs. Such invoices should be subjected to the same internal procedures as other purchase invoices.

56. Invoices from "time and material" vendors.

When purchase orders are issued for outside work on the basis of actual hours expended, to be billed at an agreed rate, the hours billed should be audited by the contractor. If material is furnished by the vendor, charges therefor will also be subject to audit.

57. Travel expense reports.

a. Procedures should be in effect for executive control over travel expense advances and for accounting controls to insure that the balances are cleared only through a proper expense report or refund of the balance of the advance. A claim for reimbursement can be made only after the travel has been completed and the contractor's procedures should recognize this requirement.

b. The procedures should provide for the submission of expense reports in accordance with the requirements listed in paragraph 20 in respect to documentary evidence.

c. In preparing claims for reimbursement, procedures should provide for excluding items such as entertainment, subsistence in excess of established limits, etc., which are not in accordance with the terms of the contract.

d. The contractor should require receipted bills in support of expenses claimed by the traveler whenever it is customary in regular business practice to issue receipts.

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TECHNICAL MANUAL

ADMINISTRATIVE AUDIT PROCEDURES FOR COST-PLUS-A-FIXED-FEE SUPPLY CONTRACTS

CHANGES No. 3

WAR DEPARTMENT,
WASHINGTON 25, D. C., 15 July 1944.

TM 14-1000, 1 March 1944, is changed as follows:

Paragraph 17, page 4, add:

h. A signed copy of each subcontract executed by the contractor will be furnished. In the case of the General Accounting Office project audit, these signed copies will be retained in the Government files.

Paragraph 50*h*, page 13, add: "However, no audit is to be made of the rates or extensions since such audit is the responsibility of the General Accounting Office."

Paragraph 125, page 31 (as changed by C 1), insert new subparagraph *e* as follows:

e. The auditor should review all miscellaneous income accounts to assure himself that credits which should be made directly to the contract are being made and that all income attributable to the operations as a whole is being properly credited to overhead.

Renumber present subparagraphs *e*, *f*, and *g* to *f*, *g*, and *h*, respectively.

Paragraph 223, page 65, at the end of the statement illustrated in this paragraph add: "The statement referred to in B 1. should be approved by the contracting officer. In the event there is no liability on the part of the contractor, a negative statement to that effect should be obtained from the contracting officer."

Remove pages 23 and 24 and substitute revised pages 23, 24, and 24A herewith.

[A. G. 300.7 (29 Jun 44).]

BY ORDER OF THE SECRETARY OF WAR:

G. C. MARSHALL,
Chief of Staff.

OFFICIAL:

J. A. ULIO,
Major General,
The Adjutant General.

DISTRIBUTION:

As prescribed in paragraph 9a, FF 21-6; Armies (10); Corps (10); Depts (10); B (2); C 14 (5); T of Opn (10).

For explanation of symbols, see FM 21-6.

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of his service or of the Army Air Forces, as the case may be.

SECTION II

INVOICES

100. Introduction.

a. The invoice audit procedure covers all vendors' invoices, transportation bills, travel expense reports, and other miscellaneous bills, whether chargeable directly to the contract, to overhead, or other accounts which may be partly applicable to the contract. The purpose of the audit procedures is to establish the credibility and allowability of all these invoices regardless of whether reimbursement is claimed immediately or at a later time through overhead.

b. The audit program will be based upon the review of internal procedures and will be adjusted to current findings.

101. Signatures.

The auditor will obtain a list of the specimen signatures and titles of persons authorized to approve or sign purchase orders, receiving reports, invoices, etc.

102. Auditing procedure—direct charges.

a. Manner of Submitting Documents by Contractor. (1) The contractor will submit his claim for reimbursement on Form No. 1034 supported by Form No. 1035, together with the invoices and related debit and credit memoranda listed thereon. The auditor will then prove the accuracy of the listing and summarization of the items included in the claim and will carry out his administrative audit.

(2) Where the auditor takes exception to particular items, which cannot be immediately adjusted, he will strike out such items on the Form No. 1035 and adjust the totals on both Forms Nos. 1034 and 1035 by drawing a single ink line through the incorrect amount and writing in the reduced amount immediately below. All changed totals should be initialed by the auditor. An extra sheet should also be prepared and attached to the Form No. 1035 detailing the downward changes made. A copy of this adjustment sheet, together with the rejected documents, will be returned to the contractor as formal notice of the rejections.

b. Examination of All Documents Submitted. All documents submitted will be reviewed for evidence, including initials and notations thereon, and by other appropriate means to determine—

(1) That invoices for materials, supplies, and other property are covered by—

(*a*) Purchase orders or agreements.

(*b*) Receiving reports approved by a Government representative.

(2) That extensions and footings have been checked.

(3) That travel expense reports, petty cash reimbursements, and invoices for services are approved by a responsible executive.

(4) That applicable deductions have been taken or that control has been established for subsequent deduction.

(5) That check numbers are shown on the invoices or on attached remittance advices.

(6) That all tax exemptions applicable to CPFF contracts have been obtained, including sales and use taxes. (See Procurement Regulation 8.)

(7) That the charge is allowable under the terms of the contract.

c. Detailed Check of Representative Number of Invoices Submitted. A representative number of invoices together with related debit and credit memoranda will be checked in detail to determine—

(1) That extensions and footings are correct.

(2) That quantities billed do not exceed the permissible variations as stated on the purchase order or allowed by the particular service.

(3) That prices and terms on the invoice agree with applicable purchase order and also with the bid in those cases where a bid was obtained.

(4) That, when required under the contract, purchase orders are approved by the contracting officer.

(5) That quantities billed are supported by receiving reports which agree either with the records retained in the receiving department or with a copy of the receiving report forwarded directly to the property accountable officer.

(6) In the case of travel expense reports—

(*a*) That unallowable expenditures because of type or amount are not included.

(*b*) That amounts claimed are in accordance with supporting documentary evidence.

(*c*) That reports are accurate as to computations.

(7) In the case of petty cash summaries—

(*a*) That supporting evidence is adequate.

(*b*) That items are correctly listed.

(*c*) That petty cash slips are properly canceled.

d. AUDIT OF TRANSPORTATION BILLS. No audit is to be made of the rates or extensions in the case of transportation bills since such audit is the responsibility of the General Accounting Office. The collection of any overpayments arising from errors in rates or extensions will be processed by that office through the disbursing officer or directly with the carrier. However, the auditor should satisfy himself that payments made are in accordance with the terms of the purchase order and supported by receiving reports.

103. Invoices from subcontractors.

Subcontractors will submit to the prime contractors their commercial invoice for reimbursement. In addition, copies of Form No. 1035 should flow directly to the auditor of the prime contract from the auditor of the subcontract.

104. Invoices from "time and material" vendors.

With respect to "time and material" invoices the auditor will assure himself that such charges have been appropriately audited by the contractor from the records of the "time and material" vendor. The audit program followed by the contractor should be reviewed in a representative number of cases and, where deemed advisable, the auditor should determine, by actual visit to the vendor's plant, that the contractor is making adequate audits.

105. Interplant or interdivisional charges.

At the originating plant the invoices will be subjected to the same auditing procedures as are set forth in this manual for reimbursement vouchers.

106. Government inspection reports on material received.

Checks will be made to see that all Government inspection reports are being reviewed by the contractor for rejections. A representative number of such reports which indicate rejections will be examined and traced to ascertain that appropriate charges have been made against vendors.

107. Receiving and inspection procedure prescribed by industrial property accounting manual.

a. With respect to the receiving and inspection of materials and other property, it is unnecessary for the contracting officer to require Government employees designated by him to duplicate completely the quantity check and quality inspection performed by the contractor in connection with materials and other property received for use on a contract provided that—

(1) Written evidence of quantity receipt, quality inspection, and acceptance is obtained from the contractor. The contractor's receiving reports are considered adequate to satisfy this requirement if—

(*a*) A written statement is obtained from the contractor listing the names of persons authorized to receive and accept materials and other property for the contractor for use on his contract in accordance with the terms of it.

(*b*) Receiving reports indicating receipt and acceptance are signed by persons authorized in accordance with (*a*) above.

(2) When the contractor's quality inspection functions are not conducted simultaneously with the quantity check, the contractor's routines provide for advising the accountable property officer of the results of such inspection when completed.

(3) The contracting officer satisfies himself that the contractor's technical methods of quality inspection are competent, that the contractor's procedures with respect to quantity receipt and physical and accounting control of such materials and property conform to good commercial practice, and that all such methods and procedures are adequate to protect the interests of the Government.

(4) The contracting officer, by frequent observation, assures himself that such procedures and methods are being effectively carried out.

b. When the provisions as outlined in *a* above have been met, the contracting officer will require only such counts and inspection by Government employees as in his judgment are suitable in the circumstances. Where quantity checks and quality inspection of specific lots of material received are made by Government employees, the following requirements will be observed:

(1) *Quantity checks.* (*a*) The Government checker will obtain the accountable property officer's copy of the contractor's receiving report as prepared by the contractor's checker and independently check the count on a surprise basis. If such a copy of the receiving report is not available, the Government checker

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Administrative audit procedure for cost-plus-a-fixed-fee supply contracts (TM14-1000)

S. J. Lenna
934 Arnold

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